No. 39 S.

Brief of Knox & Willcox for Appellee

Supreme Court of the United States.

Filed Oct. 11, 1898.

October Term, 1898.—No. 39.

Certiorari to the Circuit Court of Appeals for the Fourth Circuit.

THE SOUTHERN RAILWAY COMPANY,
Appellant,
against
THE CARNEGIE STEEL COMPANY, LIMITED,
Appellee.

OCTOBER, 1898.

BRIEF FOR APPELLEE.

P. C. KNOX,
DAVID WILLCOX,
Of Counsel for Appellee.

C. G. Burgoyne, Walker and Centre Streets, New York.

Supreme Court of the United States.

OCTOBER TERM, 1898. No. 39.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

THE SOUTHERN RAILWAY COMPANY,
Appellant,

AGAINST

THE CARNEGIE STEEL COMPANY, LIMITED,
Appellee.

October, 1898.

BRIEF,
for Appellee.

The Richmond and Danville Railroad Company, hereinafter called the Railroad Company, at the times involved, was a corporation of Virginia, with power to construct and operate a main line between Richmond and Danville and also to acquire the control of other railroad and transportation lines, in Virginia and elsewhere, by purchase or lease of such properties, and to own the stocks and bonds thereof and guarantee the same, and operate and manage all such other lines of railway and enjoy the income thereof. It had acquired the possession and control of twenty-six other railways (p. 2) situated in Virginia, North Carolina, South Carolina, Georgia, Alabama and Mississippi, which were operated as a single system without separation of earnings and expenses (p. 3). The total mileage of these roads was three thousand three hundred and twenty miles (pp. 3, 4, 155).

Under date of October 22, 1886, the Railroad Company executed

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to the Central Trust Company a mortgage known as its Consolidated Mortgage covering its own line and its most important leaseholds (pp. 56–75). The stock of the Railroad Company amounting to $5,000,000 was owned almost entirely by the Richmond and West Point Terminal Railway and Warehouse Company (p. 2), hereinafter called the Terminal Company.

Upon June 10, 1891, a contract was made by Carnegie Bros. & Co., Limited, a limited partnership under the laws of Pennsylvania, the name of which has since been changed to the Carnegie Steel Co., Limited, with the said Richmond and Danville Railroad Company (pp. 365, 370).

This provided that the Carnegie Company should deliver to the Railroad Company 2500 tons of steel rails during July, 1891, for which that Company was to pay thirty dollars per ton (p. 371); payment was to be made in the notes of the Railroad Company at four months without interest, with the privilege of one renewal for three months at five per cent interest and a second renewal for three months at six per cent interest (p. 371); the Railroad Company had the option of increasing the quantity by 200 or 300 tons, and the Carnegie Company guaranteed the rails for five years (p. 372). This option to increase the quantity was duly exercised, and by arrangement between the parties made upon July 21, 1891, the contract was further extended to cover 1,656 tons of rails, and by similar arrangement made upon October 2, 1891, it was further extended to cover 200 tons of second quality rails at the price of twenty-six dollars per ton (p. 372).

Pursuant to said contract and arrangements, the Carnegie Company delivered to the Railroad Company, between July 25, and October 10, 1891, $4{,}263\frac{350}{2240}$ tons of rails, the aggregate price of which was $125,067.39 (pp. 374, 481–484). The Railroad Company gave its notes therefor, which it renewed as contemplated in the contract. The last notes so given, which are still unpaid, were as follows (pp. 372–374):

Note for $38,251.77, dated March 21, 1892, due June 21–24, 1892.
Note for $35,499.38, dated March 24, 1892, due June 24–27, 1892.
Note for $12,786.16, dated April 4, 1892, due July 4–7, 1892.
Note for $5,355.09, dated May 16, 1892, due August 16–19, 1892.
Note for $33,174.99, dated June 7, 1892, due October 7–10, 1892.

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On June 15, 1892, William P. Clyde and two others, who alleged that they were creditors and stockholders of the Railroad Company, filed a bill against that company and the Terminal Company in the Circuit Court of the United States for the Eastern District of Virginia (p. 14).

This alleged that the character of the Railroad Company was as above stated; that it was insolvent; that "an eminent "banking firm of New York City" was investigating its affairs with the view of preparing a plan of reorganization but had reached no conclusion, and any reorganization would require considerable time (pp. 14, 15); "that the unity of the "property, as now held and operated as an important trunk line, "constitutes one of the most important ingredients of its value, "and that to permit its severance will result in a ruinous sacrifice "to every interest in the property; * * that, unless the court, "in view of the impending and inevitable defaults" (set forth in the bill), "will deal with the property as a single trust fund and "take it into judicial custody for the protection of every interest "therein that, immediately upon default, individual creditors will "assert their remedies in different courts in the several states; a "race of diligence will result; judgments and priorities will be "attempted, * * and a most important and valuable trust prop-"erty will be dismembered by the clashing decrees of the many "courts exercising jurisdiction at the suit of separate creditors, "which might be shielded and preserved as a valuable single trust "property by adequate judicial protection until such time as a sat-"isfactory financial reorganization could be perfected" (p. 16). The bill prayed, therefore, among other things, that the court "marshall "all the assets, and ascertain the several and respective liens and "priorities existing upon each and every part of all the said system "of railways, and the amount due upon each and every of such "mortgages or other liens, and enforce and decree the rights, liens "and equities of each and all of the stockholders and creditors of "said Richmond and Danville Company, * * as the same may "be finally ascertained and decreed by the court upon the re-"spective interventions or applications of each and every of such "creditors or lienors;" and that the court forthwith appoint one or more receivers of all the property of the Railroad Company (p. 18).

No default, then, had at that time, been made in the payment

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of interest or rentals (pp. 400, 401), but the bill was filed by certain stockholders and creditors to hinder the creditors generally from enforcing their rights and thus to hold the property together for purposes of reorganization (Sage vs. Memphis Co., 125 U. S., 361; Brown vs. Lake Superior Co., 134 U. S., 530; Leadville Co. vs. McCreery, 141 U. S., 475).

Upon the same day, June 15, 1892, an order was accordingly made by said court appointing Frederic W. Huidekoper and Reuben Foster as receivers of all the property of the Railroad Company (p. 20); the receivers were directed to discharge all current and unpaid payrolls, vouchers and supply accounts incurred within six months prior thereto, and the cause was set down for hearing upon August 16, 1892, upon a motion to appoint permanent receivers (p. 22). On June 16 and 17, 1892, orders appointing the same receivers were made in the other districts in which the road was situated (pp. 23, 155).

Upon June 28, 1892, the complainants petitioned the court for an order that the receivers issue certificates to the amount of $1,000,000, to take up preferential claims, so as, among other things, "*to preserve and increase the present market value of the bonds and "stocks belonging to the receivership*" (p. 20), and that "the receivers "be authorized to pay the instalments of rent and coupons of mort- "gage bonds resting upon the several parts of the system, *so as to "protect and preserve the present unity of the system of roads in "their charge*" (pp. 25-27). Attached to this petition were copies of the mortgages upon the property of the Railroad Company, which were in all cases to the Central Trust Company as trustees (pp. 28-133), and secured issues of bonds to the following amounts (p. 27):

First Mortgage dated October 5, 1874	$5,997,000
Debenture Mortgage dated February 1, 1882	3,368,000
Consolidated Mortgage dated October 22, 1886	4,498,000
Five per cent Equipment Mortgage dated September 3, 1889	1,390,000
Six per cent Equipment Mortgage dated May 1, 1891	883,000

Upon the same day, namely, June 28, 1892, *after hearing counsel* for complainants, *for the Central Trust Company* and for the receivers, and on proof of the service of notice of motion upon both of the defendants, the receivers were accordingly authorized to issue

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certificates to the amount of $1,000,000, which were made a prior lien upon the property and its income (p. 135) and were directed to be used in payment of the preferential debt (pp. 136, 137), and the receivers were ordered also, at their discretion, out of the income coming into their hands from operation of the roads, to pay accumulating instalments on car trust accounts and all maturing rental obligations of the Railroad Company (p. 137).

On July 13, 1892, the Central Trust Company filed its intervening petition in said action, praying to be made a party (pp. 138–141). This petition was granted by order entered August 16, 1892, and the Central Trust Company was made a party "on the condi-"tion that it submits to the several orders heretofore entered "herein" (p. 167). Thereafter the Trust Company had notice of all orders in the cause and in all cases consented thereto.

> "The Principal Brief for Appellant states (p. 18) that "'after the default in interest on (the consolidated) bonds "'on October 1, 1892, this class of mortgage creditors did "'not personally or by representation apply in or become "'parties in the Clyde suit.'" This was because, as just shown, their trustee had become a party therein long before, namely, on July 13, 1892. In the words of Appellant's Brief (p. 27) "the mortgagees then came into equity with their "own application," and they were necessarily bound by whatever occurred thereafter.

Upon August 12, 1892, the receivers filed a report (p. 154). This stated, among other things, that when they were appointed the Railroad Company turned over to them $480,427.91 in cash (p. 155); that the Company owed for supplies, operating accounts and taxes prior to the receivership $1,244,510.93, of which $779,974.79 arose subsequently to December 17, 1891 (p. 156); that the receivers had issued certificates amounting to $684,964.38, and were paying therefrom the claims for which such fund was constituted (p. 163); that they had paid or deposited for payment of interest and rentals and car trust rentals to the amount of $879,814 (p. 164); that the financial difficulties of the Railroad Company during the last two years "have prevented the operating officers from being able to expend "the proper amount for *new rails*, and upon the roadbed and "structures *to keep the railroad in the condition in which it should*

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"*be maintained*, and it will be necessary for the receivers, during "the summer and autumn, to make a much larger expenditure than "they would for ordinary maintenance" (p. 166).

Upon August 16, 1892, *the Central Trust Company* "*as representing the several liens on the property*," which were named and included all the mortgages upon the property of the Railroad Company, and various mortgages upon other parts of the system, together with others who were trustees for the holders of bonds secured by mortgages upon different parts of the system, petitioned the court to appoint Huidekoper and Foster as permanent receivers of the Railroad Company (pp. 167-172). Upon that day the court entered an order appointing said Huidekoper and Foster "permanent receivers in this cause with all "and singular the rights, powers, titles, duties and obligations set "forth in and by their original order of appointment, and the orders "supplemental thereto, heretofore entered in this cause" (p. 173).

The statements of of the Principal Brief for Appellant that "the mortgagee did not obtain the receivership" (p. 27) and of the additional brief (p. 14) that "with the appoint "ment of the receivers the mortgagees had nothing what-"ever to do" are erroneous, in view of the fact that the receivership was made permanent on the mortgagee's own motion; so too with the statement that "the consolidated "bondholders did not apply for judicial aid" (*Id.*, p. 27). The brief (p. 28) quotes from the Kneeland Case, 136 U. S., 89, the statement "that the bondholders were not asking "(the court) to take charge of the property, or thus impliedly "consenting to its management of the property for their "benefit." This was exactly what the Central Trust Company did in the present case.

The same order also appointed M. F. Pleasants and Thomas S. Atkins special masters to report to the court the amount and nature of all the indebtedness of the Railroad Company, and whether secured by mortgage, pledge or *other lien* upon any portion of the corporate property; and, if so, on what portion and the names of all creditors holding such demands; and directed that the special masters should give notice requiring all parties holding any indebtedness, claims or demands against the Railroad Company, except the holders of bonds secured by recorded mortgages, to file their claims with the masters on or before December 1, 1892; to the end that the validity, amount and respective priorities upon the property or income thereof

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might be determined and reported to the court, and that all creditors who failed to so present their claims should be precluded from asserting the same thereafter (pp. 173, 174).

Upon October 14, 1892, accordingly the Carnegie Steel Company, Limited, filed with the Masters an affidavit setting forth its said claim for $125,067.39 (pp. 355–357).

Under date of May 1, 1893, a plan for the reorganization of the Richmond and Danville Railroad, together with the other properties, connected therewith, was issued by Drexel, Morgan & Company (pp. 503–563). This stated that the Richmond and Danville Railroad Company had stock outstanding to the amount of $5,000,000, *nearly all owned by the Richmond Terminal Company* and floating debt to the amount of $7,000,000 (p. 507). It stated also that, "since the appointment of receivers in June, 1892, "it has been sought to hold together the various properties em- "braced in each system; and, with this object in view, coupons have "been paid from bonds on many properties which in themselves "do not warrant such payments" (p. 512). Participation in the plan was conditioned upon deposit of securities with Drexel, Morgan & Co. (p. 512). The ultimate object of the reorganization was that a new company should acquire so far as practicable the ownership of the Richmond and Danville system (pp. 513, 514). The new company was to issue $75,000,000 of Preferred Stock and $160,000,000 of Common Stock (p. 516).

In the adjustment of "Terminal Securities," it was provided that the holders of Terminal Company preferred stock should receive thirty-five per cent in new preferred stock, and sixty-five per cent of new common stock, and that holders of Terminal Company common stock (on payment of an assessment of $12.50 per share) should receive twelve and a half per cent of new preferred stock, and one hundred per cent of new common stock (p. 521). Holders of $5,500,000 of Terminal six per cent bonds were to receive certain bonds and preferred stock of the new company; and in explanation of the basis of this adjustment, it was stated that the Terminal bonds were secured, among other things, by $1,760,000 of the capital stock of the Richmond and Danville Company, and by a lien on $2,500,000 additional Richmond and Danville stock, subject to the lien of Terminal preferred stock (p. 522). The

holders of $11,000,000 of Terminal five per cent bonds were to receive certain proportions of the preferred and common stock of the new company (p. 521); and in explanation of this, it was stated that these bonds were secured, among other things, by $708,100 of the stock of the Richmond and Danville Company, and by a lien on $2,500,000 additional Richmond and Danville stock (pp. 522, 523). These provisions in favor of the holders of Terminal securities were, therefore, in large part based upon the fact that they owned the stock of the Richmond & Danville Company. Accordingly as a reason for assessment of the Terminal common stock, it was stated that "as the Terminal owns practically all the R. & D. stock, "an assessment of $7,000,000 upon it becomes necessary to clear "off the R. & D. debt" (p. 524).

It was further stated that the future Richmond and Danville earnings "(like those of previous years) cannot be secured unless "the system is held together. In case of disintegration, which can "only be avoided by a thorough reorganization throughout, the "earnings of the R. & D. cannot fail to be greatly reduced. "As matters now stand (*i. e.*, without reorganization) the sys- "tem can only be held together by paying interest on many "unprofitable lines (see pp. 39 to 41). By following this course to "some extent, the Receivers have become so depleted of cash (not- "withstanding the issue of Receivers' certificates) that they have "been obliged to default on the interest on all R. & D. mortgage "bonds, including the two issues which are ahead of the consoli- "dated 5s" (p. 533, note †).

> This plan was dated May 1, 1893, and the insolvency receivers were discharged by order entered July 17, 1893, and taking effect August 1, 1893 (pp. 240, 241). This shows that the Additional Brief for the appellant is erroneous in saying, "nor was there any attempt or scheme for reorganiza- "tion until after the first receivership had closed" (fol. 15).

On or about June 30, 1893, the Central Trust Company filed in the same court a bill to foreclose the Consolidated Mortgage of the Richmond and Danville Railroad Company (pp. 223-239). This alleged that said Company made a mortgage upon its property on October 5, 1874, to secure an issue of bonds amounting to $6,000,000, and on February 1, 1882, made a mortgage to secure an issue of debenture bonds amounting to $4,000,000 (p. 224); on October 21, 1886,

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the Company determined to issue Consolidated Mortgage bonds to the amount of $11,220,000 for the purpose of taking up prior liens, and, thereafter to an amount not exceeding $15,000 per mile of the roads of the Railroad Company (p 225); bonds thereunder were issued to the amount of $4,527,350 (p. 235), and the Railroad Company made default in the interest due October 1, 1892, and April 1, 1893 (p. 235); the bill, therefore, prayed foreclosure with appointment of a receiver in the meantime (p. 238).

On July 17, 1893, *on motion of the Central Trust Company*, complainant in said foreclosure suit, and upon hearing all who were then parties to the suit, Samuel Spencer, Frederic W. Huidekoper and Reuben Foster were appointed receivers of all the property of the Railroad Company being then in possession of the receivers previously appointed (p. 240), and were authorized to take possession upon August 1, 1893, and continue to operate the property (p. 241). The order contained the following reservation: "Nothing in this order contained shall be construed to vacate any of the orders heretofore "entered in the case of William P. Clyde and others; but the court "reserves full power to act upon the masters' reports filed in the "said cause, and in said cause to adjudge and decree upon the "rights of creditors asserting a claim against the property of the "said railroad company or income thereof in preference to the "mortgage debt thereof, by orders to be entered in the said suit of "William P. Clyde and others, upon notice to parties, with like "effect upon the mortgaged property and income as if such orders "were entered in this cause" (p. 243). This reservation was, of course, binding upon the bondholders (New England Co. vs. Carnegie Co., 75 Fed. Rep., 59).

Upon August 21, 1893, an order was made appointing an auditor to pass the accounts of the prior receivership (p. 220). Upon March 3, 1894, the auditor reported, stating the accounts of the receivers from June 16, 1892, to July 31, 1893. The total of each side of the account was $15,432,055.36. The receipts included, Cash on hand when the receivers were appointed, $480,427.91, and Received from accounts prior to their appointment $671,363.40, making together $1,151,791.31, and Earnings during receivership, $14,280,264.05. The disbursements included, Accounts prior to appointment of receivers, $1,237,196.22; Interest and rentals, $3,253,956.89; Car

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Trust Payment and Sinking Fund, $481,893.16; Cash balance to new receivers, $141,325.19; Other items, $10,317,683.90. An order confirming this statement was made upon April 13, 1894 (pp. 222, 223). As will be seen hereafter, these figures vary slightly, but not substantially, from the facts proved upon the hearing of the present claim.

On August 21, 1893, an order was entered, by consent of all who were then parties, providing that the foreclosure receivers, "out "of the income coming into their hands from the operation of the "roads in their charge, which in their judgment can safely be used "without prejudice to the payment of their own current obligations, "are authorized, exercising their discretion as to the best interests "of the trust estate, to pay the instalments hereafter accruing on "car trust and equipment contracts, and on all rental obligations "assumed by the Railroad Company, in any of the leases or operat- "ing contracts relating to the roads now being operated by the "receivers" (p. 244). On the same day an order was made authorizing the receivers to pay interest upon the secured floating debt (p. 245).

On February 17, 1894, an order was made consolidating the Clyde suit and the foreclosure suit (pp. 249, 364).

On March 1, 1894 (p. 365), the Carnegie Steel Company, Limited, filed a petition further setting forth its claim. This stated the amount and origin thereof; that the rails sold by it were used by the Richmond and Danville Company in its roadbed for the purpose of maintaining the same in condition to conduct its traffic and were necessary therefor; that the petitioner was equitably entitled to have the earnings of the Railroad Company applied to the payment of its claim before any part thereof was paid to the holders of the bonded debt of said company; that, prior to appointment of receivers in the Clyde case, large sums were paid by the Railroad Company to its bondholders in payment of interest and to others for their exclusive benefit, and since their appointment other large sums, more than sufficient to pay petitioner's claim, had been paid out and expended to the holders of said bonded debt, by reason whereof the petitioner's claim had been left unpaid, and the sums so paid out were

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from the earnings of the Railroad Company (pp. 366, 367); that, although the reorganization plan provided for payment of the floating debt, the reorganization committee did not intend to carry it out in that respect (p. 368), and the plan provided for issuing new securities to the stockholders of the old company, which course would be in fraud of creditors (p .368). The petitioner, therefore, prayed to be allowed to intervene for protection of its rights (p. 370).

By order entered the same day the Carnegie Company was joined as a defendant in the cause (p. 375). On March 8, 1894, the Central Trust Company filed an answer to this petition admitting the facts, for the most part, but denying any right of the petitioner to priority (pp. 375–378).

Upon March 16, 1894, the Carnegie Company filed an amendment to this petition by which it claimed a lien also under Sec. 2485 of the Code of Virginia (pp. 379, 380).

On April 13, 1894, a decree of foreclosure was entered (p. 262). This found that bonds had been issued under the Consolidated Mortgage to the amount of $4,527,350 (p. 273), and that default had been made in the payment of interest on October 1, 1892, and April 1, 1893 (p. 273); the total amount due was fixed at $5,002,155.81 (p. 275), and sale of the premises was ordered (p. 276). It was ordered, also, that the purchaser should take subject to any claims which might thereafter be adjudged to be prior to the consolidated mortgage bonds (pp. 280, 282). Upon June 15, 1894, a report was filed of the sale under the decree, setting forth that the property had been sold for $2,030,000, subject to all preferential claims (p. 291). On the same day an order was entered confirming the sale, subject to all claims which might be adjudged to have prior equity (p. 298), and the court reserved the right to enter orders binding upon the purchaser, the Southern Railway Company, directing payment of such claims (p. 299), and to order a resale if the same should not be made (p. 301).

Upon the hearing of the issues, raised by the petition of the Carnegie Company, as amended, and the answer of the Central Trust Company, before the Special Masters, the following facts were proved.

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Of the total issue of Consolidated Mortgage bonds $1,621,000 were issued prior to May 1, 1888, and the balance, $2,906,000, thereafter (pp. 385-389). All floating debt of the Railroad Company for materials and supplies furnished within six months prior to the receivership had been paid (p. 395). The total amount of labor and supply claims filed against the Richmond and Danville Company and remaining unpaid was $318,324.71, which included the claim of the Carnegie Company (pp. 395, 398). This total amount, however, included a claim of Pullman's Palace Car Company for $90,752.81, which was largely for car mileage, and of the Western Union Telegraph Company for $22,186.53, which was largely for constructing telegraph lines. Deducting these, the only labor and supply claims remaining unpaid were that of the Carnegie Company for $125,067.39, and those of various others aggregating $80,317.98, making $205,385.37 in all (pp. 395, 398).

When Huidekoper and Foster were appointed receivers under the Clyde bill, upon June 17, 1892, they received in cash from the Railroad Company $480,427.91, and subsequently collected from earnings prior to the receivership $671,363.40 (p. 399, 424), making together $1,151,791.31 (pp. 403, 424). The total sum paid out on account of operations prior to the receivership was $1,237,196.22 (pp. 403, 425), making the balance of payments over receipts for the period prior to the receivership $85,404.91.

The operations of the insolvency receivership from June 17, 1892, to July 31, 1893, resulted in net earnings over operating expenses, including taxes, of $3,297,792.31 (p. 399); these net earnings were used by the insolvency receivers in paying Extraordinary Expenses, principally for Construction and Equipment, $559,734.62; and interest, rentals, dividends, sinking fund and car trust payments, with some other small items, $3,330,346.99 (p. 422); but after deducting from the net earnings the amounts thus expended, the operations resulted in a deficit of $592,289.30 (pp. 399, 422, 432). This deficit was provided for largely from cash or material received by the receivers upon their appointment (p. 400). The receivers turned over to their successors a cash balance of $141,325.19 (pp. 424, 425, 426). The gain from operating the Richmond and Danville road proper between June 17, 1892, and July 31, 1893, was $346,163.10 (p. 402). Interest was paid upon

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the first mortgage bonds in January, 1892, to the amount of $179,310, and the coupons thereon due July 1, 1892, and January and July, 1893, were paid by the receivers, amounting in all to about $525,000 (p. 401).

Between August 1, 1893, and December 31, 1893, the net earnings of the foreclosure receivers were $1,127,861.09, as against which $77,081.73 were expended for Extraordinary Expenses, principally Construction and Equipment, $716,810.84 for Interest, Rrentals, Sinking Fund and Car Trust payments (p. 423); $11,785.73 on account of operations prior to the insolvency receivership (p. 403), and the cash balance remaining on hand was $343,546 95 (p. 428). The foreclosure receivers turned over the property to the Southern Railway Company upon June 30, 1894 (p. 301). The record does not contain a detailed account of their operations between December 31, 1893, and June 30, 1894. A report which they made on July 13, 1894, stated, however, that their net liabilities at the close of the foreclosure receivership were about $500,000, and that they turned over to the purchaser, the Southern Railway Company, supplies of about the same value (pp. 303, 306, 307). This, shows, of course, that the foreclosure receivers between August 1, 1893, and June 30, 1894, expended for Extraordinary Expenses, principally Construction and Equipment, $77,081.73, and for Interest, Rentals, Sinking Fund and Car Trust payments $716,810.84, and at the close had assets sufficient to pay their debts.

Upon May 19, 1894, the Masters reported that the Carnegie Company was a creditor of the Railroad Company in the amount of $125,067.39; that it was not entitled to a preference by reason of diversion of earnings, but was entitled to a preference over all the consolidated bonds save $1,621,000 thereof by reason of the Virginia lien statute of May 1, 1888 (Code, Sec. 2585, pp. 383–385), Exceptions were filed by both parties (pp. 468, 469). The Circuit Court sustained the exceptions of the Carnegie Company, finding that "the earnings of said defendant Railroad Company, which "should have been used for the payment of current expenses, in- "cluding therein this claim, have been used for the benefit of mort- "gage creditors, in a sum more than sufficient to pay said claim in "full" (p. 470). The exceptions of the Central Trust Company were

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overruled (p. 471) and the Southern Railway Company was ordered to pay to the Carnegie Company the sum of $154,895.97, being the amount of the claim with interest (p. 471).

The Southern Railway Company duly appealed to the Circuit Court of Appeals (pp. 472–478). The decree below was there affirmed upon November 10, 1896 (pp. 486–499; 76 Fed. Rep., 492). Upon January 12, 1897, this court granted a writ of *certiorari* (pp. 565, 566; 165 U. S., 720). The present hearing is upon the return to that writ.

FIRST.

If current earnings are used for the benefit of mortgage creditors before current expenses are paid, the mortgage security is chargeable in equity with restoration of the fund which has been thus misapplied.

The fact that the general supply creditor has given the Railroad Company a term of credit and accepted notes in the meantime does not affect his equities. When his debt becomes due, he is none the less entitled to have the current earnings applied to the payment thereof.

These rules are exactly laid down in Burnham vs. Bowen, 111 U. S., 776. The facts were that a receiver of the property of the Railroad Company was appointed upon January 13, 1875. At that time the Railroad Company was indebted to Bowen for coal furnished during the year 1874, for which, however, he held the acceptances of the company which were renewed after the appointment of the receiver. In January, 1876, Bowen petitioned for payment of his claim. Subsequently to the appointment of the receiver somewhat over $25,000 was expended in purchasing lands and paying judgments for rights of way. On October 18, 1878, Bowen filed a further petition for the payment of his claim, and upon October 30, 1880, a decree was entered finding the amount due to him to be the sum of $6,515.42, and declaring that the mortgaged property in the hands of the trustees under a decree of strict foreclosure, which had been entered theretofore, was equitably bound for the payment thereof. The court held that a debt contracted by a railroad corporation as part of its necessary operating expenses is a privileged debt entitled to be paid out of current income in case the mortgage trustees take possession, or a receiver be appointed in a foreclosure suit; that if the current income of the road is diverted to the improvement of the property by the trustees in possession or by the receiver, and the mortgage is foreclosed without payment of such debts for operating expenses, an order should be made for their payment out of the fund if the property is sold, or if a strict foreclosure is had they should be charged upon the income after foreclosure, and the fact that the supply creditor has accepted a note representing his claim does not affect his equities.

Points.

First. The mortgage security is chargeable with earnings diverted.

The court said: "The business of every railroad com-
" pany is necessarily done more or less on credit, all parties
" understanding that current expenses are to be paid out of current
" earnings. Consequently, it almost always happens that the current
" income is incumbered to a greater or less extent with current debts
" made in the prosecution of the business out of which the income
" is derived. As was said in Fosdick vs. Schall, 99 U. S., 235, 252,
" 'the income (of a railroad company) out of which the mortgagee
" 'is to be paid is the net income obtained by deducting from the
" 'gross earnings what is required for necessary operating and
" 'managing expenses, proper equipment and useful improvements.
" 'Every railroad mortgagee in accepting his security impliedly
" 'agrees that the current debts made in the ordinary course of
" 'business shall be paid from the current receipts before he has
" 'any claim on the income." Such being the case, when a court of
" chancery, in enforcing the rights of mortgage creditors, takes
" possession of a mortgaged railroad and thus deprives the company
" of the power of receiving any further earnings, it ought to do
" what the company would have been bound to do if it had remained
" in possession—that is to say, pay out of what it receives from
" earnings all the debts which in equity and good conscience, con-
" sidering the character of the business, are chargeable upon such
" earnings. In other words, what may properly be termed the
" debts of the income should be paid from the income before
" it is applied in any way to the use of the mortgagees.
" The business of a railroad should be treated by a
" court of equity under such circumstances as a 'going concern,'
" not to be embarrassed by any unnecessary interference with the
" relations of those who are engaged in or affected by it. In the
" present case, as we have seen, the debt of Bowen was for current
" expenses and payable out of current earnings. It does not ap-
" pear from anything in the case that there was any other liability
" on account of current expenses unprovided for when the receiver
" took possession, and there is nothing whatever to indicate that
" this debt would not have been paid at maturity from the earnings
" if the court had not interfered at the instance of the trustees for the
" protection of the mortgage creditors" (pp. 780, 781).

The court then considered the contention that as no part

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of the income before the appointment of the receiver was used to pay the mortgage interest or to make permanent improvements on the property, or to increase the equipment, there was no such diversion of the funds belonging in equity to the labor and supply creditors as to make it proper to use the income of the receivership to pay them. It said that the debt due Bowen was incurred to keep the road running, and thus preserve the security of the bond creditors. There certainly was no complaint of a diversion by the company before the receiver was appointed of the current earnings from the payment of the current expenses. "Under these circumstances, we think the debt was a "charge in equity on the continuing income, as well that which "came into the hands of the court after the receiver was appointed "as that before. When, therefore, the court took the earnings "of the receivership and applied them to the payment of the fixed "charges on the railroad structures, thus increasing the security "of the bondholders at the expense of the labor and supply "creditors, there was such a diversion of what is denominated in "Fosdick v. Schall the 'current debt fund,' as to make it proper to "require the mortgagees to pay it back. So far as current expense "creditors are concerned, the court should use the income of the "receivership in the way the company would have been bound in "equity and good conscience to use it if no change in the possession "had been made. This rule is in strict accordance with the decision in Fosdick v. Schall, which we see no reason to modify in "any particular (p. 782). It was no waiver of any claim on the "fund which might come into the hands of the receiver to renew "the paper at maturity for the convenience of the holder. It was "undoubtedly given originally to enable the coal company to use it "as commercial paper if occasion required, and the renewal may "have become desirable on account of the use which had been "made of it" (p. 783). The court finally stated it to be the rule that, "if current earnings are used for the benefit of mortgage "creditors before current expenses are paid, the mortgage security "is chargeable in equity with the restoration of the fund which has "been thus improperly applied to their use" (p. 783).

In Hale vs. Frost, 99 U. S., 389, the court held that a railway mortgage was a prior lien only upon the net earnings

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of the road after the payment of all operating expenses, and that the earnings in the hands of a receiver were subject to the disposition of the court in the payment of claims having superior equities. Accordingly it sustained an order directing payment of an account for car springs and spirals and supplies for the machinery department furnished in part three years before the appointment of the receiver, but which the receiver continued to use, notwithstanding that the Railroad Company's notes had been given for the amount so due.

In Union Trust Company vs. Morrison, 125 U. S., 591, a railroad company procured an individual to become a surety upon an injunction bond given in a suit brought to prevent a levy upon its rolling stock. Six years afterward that suit was finally determined and the surety became liable. A receiver of the property had been appointed in the meantime at the instance of the mortgage trustees. It was held that the act of the surety on the injunction bond had operated to keep the property together and to keep the railroad as a going concern, and, as the testimony showed that the receivers had received income from which they might have discharged the liability, a decree was proper directing that a purchaser at the sale should pay the amount paid out by the surety.

In St. Louis, Alton & Terre Haute R. R. Co. vs. Cleveland Co., 125 U. S., 658, a claim was made that the rental of a leased line was properly chargeable against the proceeds of the road realized from sale of the same under foreclosure. The court held that such rental was not properly a preferred debt. It stated the rules upon the subject as follows: "There are cases, it is true, where, owing to special circum- "stances, an equity arises in favor of certain classes of cred- "itors of an insolvent railroad corporation, otherwise unse- "cured, by which they are entitled to outrank in priority of "payment, even upon a distribution of the proceeds of a sale "of the body of the property, those who are secured by prior "mortgage liens. Illustrations and instances of these cases "are to be found in Fosdick vs. Schall, 99 U. S., 235; Mil- "tenberger vs. Logansport Railway Co., 106 U. S., 286; "Union Trust Co. vs. Souther, 107 U. S., 591; Burnham vs. "Bowen, 111 U. S., 776; Union Trust Co. vs. Illinois Mid- "land Railway Co., 117 U. S., 434; Dow vs. Memphis and "Little Rock Railroad Co., 124 U. S., 652; Sage vs. Memphis "and Little Rock Railroad Co., *ante*, 361, and Union Trust Co. "vs. Morrison, *ante*, 591. The rule governing in all these "cases was stated by Chief-Justice WAITE in Burnham vs.

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" Bowen, 111 U. S., 776, 783, as follows : ' That if current " ' earnings are used for the benefit of mortgage creditors be- " ' fore current expenses are paid, the mortgage security is " ' chargeable in equity with the restoration of the fund " ' which has been thus improperly applied to their use.' " *There has been no departure from this rule in any of the " cases cited ; it has been adhered to and reaffirmed in them " all*" (pp. 673, 674).

In Kneeland vs. American Loan and Trust Co., 136 U. S., 89, a receiver was appointed upon the application of a judgment creditor. This receivership continued four months, when a receiver in foreclosure was appointed. Upon a sale of the property a claim was made that car rentals which accrued during the first receivership should be given priority to the mortgage debt. The court held to the contrary. It said that the " case is not embarrassed by any matter of " surplus earnings, for it appears, beyond any possibility of " doubt, that from the time of the purchase of this rolling " stock to the time of the final disposition of these cases " the receipts did not equal the operating expenses. There " was no diversion of the current earnings, either to the pay- " ment of interest or the permanent improvement of the " property " (p. 96). To the same effect is Morgan's Steamship Company vs. Texas Ry. Company, 137 U. S., 171.

In Thomas vs. Western Car Co., 149 U. S., 95, the question was again whether a claim for car rentals was entitled to priority as against the proceeds of the property. There was no question of diversion. The court held that it was not to be regarded as a preferred debt as against the *corpus* of the property (p. 112). This case was followed in Pullman's Palace Car Co. vs. American Loan & Trust Co., 84 Fed. Rep., 18.

In Virginia and Alabama Coal Co. vs. Central Railroad Co., 170 U. S., 355, the rules governing the present case have just been fully and conclusively restated. The Richmond and Danville Railroad Company was operating the lines of the Central Railroad and Banking Company of Georgia. Upon July 13, 1891, it made a contract with the Coal Company to furnish coal to the Central Company. Coal was furnished thereunder of the value of $26,607.44, and this was used partly on the lines of the Central Company and partly on lines connected therewith, which were operated by the Richmond and Danville Company, and in part by the receivers of the Central Company after their appointment as hereafter stated. On March 4, 1892, an action was brought to vacate the lease under which the

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Richmond and Danville Company was operating the lines of the Central Company, and a receiver of the latter company was appointed. On July 15, 1892, in an insolvency suit by the Central Company itself, this receivership was continued. On January 23, 1893, a dependent bill of foreclosure upon the main system of the Central Company was filed in the insolvency suit and the receivership was extended to that bill. On May 26, 1892, the Coal Company intervened and alleged the furnishing of the coal as above stated. In the proceedings on said intervention it was stipulated further that, since the receivership, the receivers of the Central Company had expended for betterments on its railroad lines, from the income of the road during the receivership, a sum much larger than the entire claim of the intervenors. The Circuit Court of Appeals held that the Coal Company was entitled to a decree for payment by the receivers for all coal furnished to lines under the contract and forming part of the system of the Central Company, including both what had been used before the receivers were appointed and that which was on hand at that time.

This decision was affirmed by this court. It stated the facts and rulings in Burnham vs. Bowen, 111 U. S., 776, and said, "it "was thus settled that where coal is purchased by a railroad "company for use in operating lines of railway owned and controlled "by it, in order that they may be continued as a going concern, and "where it was the expectation of the parties that the coal was to be "paid for out of the current earnings, the indebtedness, as between "the party furnishing the materials and supplies and the holders of "bonds secured by a mortgage upon the property, is a charge in "equity on the continuing income, as well that which may come "into the hands of a court after a receiver has been appointed as "that before. It is immaterial in such case, in determining the "right to be compensated out of the surplus earnings of the re-"ceivership, whether or not during the operation of the railroad by "the company there had been a diversion of income for the benefit "of the mortgage bondholders, either in payment of interest on "mortgage bonds or expenditures for permanent improvements upon "the property. Nor is the equity of a current supply claimant in "subsequent income arising from the operation of a railroad under "the direction of the court affected by the fact that, while the com-"pany is operating its road, its income is misappropriated and di-

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"verted to purposes which do not inure to the benefit of the mort-
"gage bondholders and are foreign to the beneficial maintenance,
"preservation and improvement of the property." In support of this the court cited with approval Miltenberger vs. Logansport Co., 106 U. S., 286; Union Trust Co. vs. Illinois Midland Co., 117 U. S., 434; and Thomas vs. Western Car Co., 149 U. S., 95 (p. 365). * *

"The dominant feature of the doctrine, as applied in Burn-
"ham vs. Bowen, is that, where expenditures have been made
"which were essentially necessary to enable the road to be
"operated as a continuing business, and it was the expectation
"of the creditors that the indebtedness created would be paid out
"of the current earnings of the company, a superior equity arises
"in favor of the materialman as against the mortgage bonds in
"the income arising both before and after the appointment of a
"receiver from the operation of the property.

"The equity thus held to arise when a purchase of necessary
"current supplies is made by the owning company is not in any
"wise influenced by the fact that the company itself is the pur-
"chaser of the supplies, but is solely dependent upon the fact that
"the supplies are sold and purchased for use and that they are
"used in the operation of the road, that they are essential for such
"operation, and that the sale was not made simply upon personal
"credit, but upon the tacit or express understanding that the cur-
"rent earnings would be appropriated for the payment of the
"debt (p. 368). * *

"Upon the evidence contained in the record we hold that the
"contract upon which both intervenors relied—the deliveries of
"coal furnished by the Sloss Company being under the contract
"which had been made with the Virginia Company—was made with
"the Danville Company, but we conclude from the terms of the
"contract that the intention of the parties was that the coal was to
"be used in the operation of the lines of the Central Company, and
"that the mining companies did not rely simply upon the respons-
"bility of the Danville Company, but, on the contrary, that the
"coal companies looked to the earnings of the Central system as
"the source from which the funds to pay for the coal to be fur-
"nished was to be derived.

"While it was established that during the time the Danville

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" Company was in control of the Central property a semi-annual
" instalment of interest—which exceeded the amount of the claims
" of the intervenors—was paid to the holders of the bonds of the
" Central Company, we cannot say that there was a diversion of in-
" come from the Central lines for such purpose. At the best, it
" could only be conjectured that such payment was probably made
" from that income. Whether, however, there was a diversion of in-
" come before the receivership, inuring to the benefit of
" the bondholders, the equity in favor of the Coal Company for
" payment out of subsequent income, as we have seen, survived and
" attached to the property when it was taken possession of by the
" receiver; and if a surplus of income was created by the opera-
" tions of the road under the receiver, sufficient to satisfy the
" claims of the intervenors, the right to demand that the surplus
" income be applied in satisfaction of the claims in question was
" undoubted. From the evidence we find that there was such sur-
" plus. It was stipulated in the record as a fact, 'that since the
" 'receivership, the receivers of the Central Railroad and Banking
" 'Company of Georgia have expended for betterments on its railroad
" 'lines from the income of the roads during the receivership a sum
" 'much larger than the entire claim of the intervenors' (p. 369).
" Keeping in mind the manifest purpose of this stipulation, which
" undoubtedly was to present the question of the right of the
" claimants to resort to the *corpus* of the estate for payment of their
" claims, we must give the term 'betterments' a broad and not a
" restricted meaning. So construed, it must be held to have re-
" ferred to expenditures for the improvement of the property as
" distinguished from mere payments for operating expenses and
" ordinary repairs, which are usual and legitimate terms of outlay
" from current receipts. This is the sense in which the term was
" understood by this court in Union Trust Company vs. Illinois
" Midland Company, 117 U. S., 434, where the validity of receiver's
" certificates was upheld which had been paid out of the proceeds of
" the sale of the *corpus* of the property because issued to re-
" place earnings diverted from paying operating expenses and
" ordinary repairs for payment of betterments (p. 462).
" The circumstance that it is uncertain, from the terms of the stipu-
" lation, whether the expenditures for betterments were made by

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"the receivers under the stockholders' bill, or under the bill filed "by the Central Company or under the trustee's bill for foreclosure, "is immaterial. Even though the mortgages securing the bonds "provided for the sequestration by foreclosure of the income of the "road for the benefit of the bondholders for reasons already stated, "that income, until strict foreclosure or a sale of the road, was "charged with the prior equity of unpaid supply claimants, such as "those now before the court.

"In concluding that the claims of the intervenors were entitled "to priority out of the surplus earnings which arose during the "control of the road by the court, we must not be understood as "in any wise detracting from the force of the intimations con- "tained in the recent utterances of this court in the Kneeland "(136 U. S., 89) and Thomas (149 U. S., 95) cases, as to the neces- "sity of a court of equity confining itself within very restricted "limits in the application of the doctrine that in certain cases a "court, having a road or fund under its control, may be justified "in awarding priority over the claims of mortgage bondholders to "unsecured claims originating prior (p. 370) to a receivership. In "the Kneeland case, however, the claim refused priority was based "upon an alleged instrument of lease, and was for four months' "rental of cars operated on a line of railroad by a receiver ap- "pointed at the suit of a judgment creditor, such receiver being "succeeded in office by a receiver appointed in the foreclosure "proceedings instituted by the trustees of the mortgage bondholders. "It was held that the alleged contracts of lease were in substance "and effect 'antecedent contracts of sale;' that in those contracts "ample provision had been made by the vendor for his security by "stipulations authorizing a retaking of the property upon failure to "make payment promptly of the instalments of purchase money as "they became due, and that the claim against the fund was in "reality for a portion of the purchase price of the cars. Under "these circumstances, the debt was held not to be embraced 'in the "'few specified and limited cases' in which the court 'has declared "'that unsecured claims were entitled to priority over mortgage "'debts;' and particular attention was called, among other things, "to the fact that the receivership at the suit of the judgment "creditor was not for the benefit of the mortgage bondholders, so

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"that it could not be asserted that the expenditures of such "receivership were payable in any event out of the income or *corpus* "of the property; and the fact was also noticed that from the time "of the purchase of the rolling stock in question in the suit to the "time of the final disposition of the mortgage foreclosure the "receipts did not equal the operating expenses, and there had been "no diversion of the current earnings, either to the payment of "interest or the permanent improvement of the property. In the "Thomas case claims for rental of cars, which rental had accrued "prior to the receivership, were denied priority over the mortgage "bonds, but the facts in that case were such as to justify the con- "clusion that the Car Company contracted 'upon the responsibility "' of the Railroad Company, and not in reliance upon the interposi- "'tion of a court of equity.' In neither the Kneeland nor the "Thomas case was there any intention to question the prior de- "cisions of the court, which allowed priority to claims based upon "the (p. 371) furnishing of essential and necessary current supplies, "not sold upon mere personal credit, against the surplus income "arising during the operation of the road under the direction of a "court of equity (p. 372)."

In Atkins vs. Petersburg Railroad Company, 3 Hughes, 307, 2 Fed. Cases, 90, advances were made for the payment of back wages due, upon a distinct understanding that they should be reimbursed out of the first net earnings of the company, and that the money advanced should be paid to the employees. Some two years afterward a receiver was appointed. It was held that the advances must be paid, in preference to claims of mortgagees, out of income accruing while the road was in the custody of the court. The court stated the rule to be that a court may order the payment of such debts incurred by a railroad company before the appointment of a receiver, as it may authorize a receiver to contract and pay after his appointment, provided that the *corpus* of the property be not touched.

In U. S. Trust Co. vs. N. Y., W. S. & B. Co., 25 Fed. Rep., 800, receivers were appointed under foreclosure of a mortgage. An application was made by a party who had furnished clocks to the company prior thereto for an order directing payment of his claim. The court held that if any income from the road had been left in the hands of the receiver for the payment of current running expenses there

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would have been no difficulty about the case, as it would be only equitable to require the receiver to do what the company would be expected and ordered to do if it had remained in possession of the property; namely, to use the current receipts for the payment of current debts.

In Farmers' L. & T. Co. vs. Vicksburg & M. R. Co., 33 Fed. Rep., 778, it was held that, where current debts are incurred by a railroad company in the course of its current business, they are chargeable upon the current income as against holders of mortgage bonds of such railroad, whether they accrued before or after the railroad went into the hands of a receiver; and the fact that such debts were incurred for betterments does not affect the right to have them paid out of the current income when the proofs show such betterments to have been necessary. In this case the claim arose from expenditures upon the right of way consisting in large part of furnishing rails necessary therefor.

In Thomas vs. Peoria Ry. Co., 36 Fed. Rep., 808, the court (HARLAN, J.) stated that one of the rules governing the subject was that, while ordinarily this power is confined to the appropriation of the income from the receivership and the proceeds of mortgaged assets which have been taken from the company, cases may arise that will require the use of the proceeds of the sale of the mortgaged property in the same way; as when, before the appointment of the receiver, or in the *administration of the cause*, income applicable to the payment of old debts for current expenses is taken and used to make permanent improvements in the fixed property or to buy additional equipment.

In Farmers' L. & T. Co. vs. Green Bay Co., 45 Fed. Rep., 664, the court stated that the power rests upon the fact of diversion of a fund belonging in equity to the general creditors or some of them (p. 665). The test is benefit to the *res* (p. 666).

In Bound vs. South Carolina Railway Co., 58 Fed. Rep., 473, upon which the appellant has principally relied, the facts were totally different. There was no diversion of income in that case, and the question was whether the claim should be charged against the *corpus* of the property. The court held merely that there were no facts established making this course proper. The claim was not disallowed because the subject thereof was steel rails, as appellants' Additional Brief seems to intimate (p. 10). Nor was it held, as the Principal Brief for appellant (p. 36) states that the credit given "waived all claim upon the current earnings." The

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court expressly said that the credit showed that, "*during* "*that period*," the creditor contemplated application of the earnings to payment of interest. In Lackawanna Iron Co. vs. Farmers' Loan and Trust Co., 79 Fed. Rep., 202, there seems to have been no diversion of income.

In Wood vs. N. Y. & N. E. R. R. Co., 70 Fed. Rep., 741, the court held that there is no fixed and inflexible rule in respect to the allowance, out of the earnings of a railroad in the hands of a receiver, of unsecured claims for current debts, but each case is largely governed by its own circumstances. Such allowance does not depend on any fixed rule as to the time when the debts were contracted, nor upon the order appointing receivers. Where there has been a diversion of current income from the payment of current debts to the payment of interest on a mortgage, or the making of permanent improvements, there should be a restoration to the extent of such diversion, and, independently of diversion, debts may be preferred which are incurred for labor and supplies necessary to keep the road a going concern, or which grew out of indispensable business relations. Accordingly it was held that the appellee in the present case, the Carnegie Company, was entitled to payment for coupling links and pins and link steel necessary to operation of the railroad. This was affirmed by the Circuit Court of Appeals in 75 Fed. Rep., 54, 59.

In Central Trust Co. vs. East Tennessee Co., 80 Fed. Rep., 624, 628, the court says that "from these cases it may be "deduced that in respect of railroad mortgages there is an "implied agreement that all proper operating expenses of "such companies, while under control of the mortgagors, are "to be paid out of current receipts, and that any diversion "of such income by which current operating expenses are "left unpaid, is a misappropriation of the income, and upon "a proper showing the mortgagees receiving the benefit will "be required to reimburse the fund applicable to the payment of these 'debts of the income,' to the extent of the "diversion." Inasmuch as this case is cited by Appellant Brief (p. 21) as an authority, it is proper to note that no diversion of income was shown there.

In New York Guaranty and Indemnity Company vs. Tacoma Railway Company, 83 Fed. Rep., 365, the claim was for priority by reason of a debt arising from furnishing, more than two years before the appointment of the receiver, a cable to a cable railway. The court held that, inasmuch as the cable was necessary to keep the road a going concern, the claim for its price was entitled, on insolvency of the company and

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the appointment of a receiver, to priority over the mortgage bonds, and that too without showing any diversion of income. The court stated it to be the principle established by the authorities that "such claims are preferred over the mort-"gage lien when they involve debts incurred which were nec-"essary 'to keep the road a going concern,' or which are the "outcome of indispensable business relations, a continuance "of which involves the interests of the public and the traffic "of the road" (p. 367).

To the same effect are Central Trust Co. vs. East Tenn. Co., 30 Fed. Rep., 895, 897; Easton vs. Houston Co., 38 Fed. Rep., 12, 14; Finance Co. vs. Charles Co., 48 Fed. Rep., 188; Northern Pacific Co. vs. Lamont, 69 Fed. Rep. 23; St. Louis Trust Co. vs. Riley, 70 Fed. Rep., 32, 37; Veatch vs. Amn. Loan & Trust Co., 84 Fed. Rep., 274; Grand Trunk Railway Co. vs. Central Vermont Co., 88 Fed. Rep., 620; Boston Safe Deposit Co. vs. Richmond and Danville Co., 8 U. S. Appeals, 547.

These authorities fully establish the rule that, when current earnings are used for the benefit of the mortgage creditors before the current expenses are paid, the mortgage security is chargeable in equity with restoration of the fund which has been thus misapplied.

The suggestion (Additional Brief for Appellant, p. 10) that these supplies were used for "construction purposes" and are, therefore, not entitled to payment, is sufficiently answered by the statement that they were used for "reconstruction purposes (*Id.*, p. 10)—for reconstruction of the Railroad Company's worn-"out or destroyed property" (*Id.*, p. 12). That certainly shows, beyond question, that they were supplies needed to maintain the railroad as a going concern and were, therefore, entitled to the benefit of the rules already stated. Those rules have frequently been applied to material similar to that now involved. Thus, in Hale vs. Frost, 99 U. S., 389, the subject of the claim was car springs and spirals and machinery supplies; in Farmers' Loan and Trust Co. vs. Vicksburg Railroad Co., 33 Fed. Rep., 778, it was steel rails; in Wood vs. New York & N. E. Ry. Company, 70 Fed. Rep., 741, 75 Fed. Rep., 54, 59, it was coupling links and pins and link steel; in New York Guaranty Co. vs. Tacoma Ry. Co., 83 Fed. Rep., 365, it was a steel cable.

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The cases above stated fully answer the other objections urged by Appellant. Thus, Burnham vs. Bowen, 111 U. S., 776, holds that giving a term of credit represented by obligations of the company does not waive the right to priority, even although such obligations be renewed after the appointment of the receiver (p. 783), and the same thing is held in Hale vs. Frost, 99 U. S., 389; so, too, in Bound vs. South Carolina Railway Co., 58 Fed. Rep., 473, the court significantly says that the effect of extending credit is to suspend the right to priority "*during* that period." That there is no special limitation regarding the time when the supplies have been furnished is held in Hale vs. Frost, 99 U. S., 389; Burnham vs. Bowen, 111 U. S., 776; Union Trust Co. vs. Morrison, 125 U. S., 591; Atkins vs. Co., 3 Hughes, 307; Northern Pacific Co. vs. Lamont, 69 Fed. Rep., 23; N. Y. Guaranty Co. vs. Tacoma Ry. Co., 83 Fed. Rep., 365.

The present case is, therefore, within the general rules, if the facts establish diversion of the income.

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Current earnings were used for the benefit of the mortgage creditors instead of paying therewith current expenses, including the debt of the Carnegie Company.

The consolidated mortgage was a lien both upon the property owned by the Railroad Company and also upon its more important leaseholds (pp. 56–75). The express purpose and the effect of all the proceedings taken was to keep the system together for the benefit of the security holders. The bill filed by Clyde and others upon June 15, 1892, alleged that "an eminent banking firm of New York City" is preparing a plan of reorganization, and any reorganization will require a considerable time (pp. 14, 15); that the "unity of the property, as now "held and operated as an important trunk line, constitutes "one of the most important ingredients of its value, and to "permit its severance will result in a ruinous sacrifice to every "interest in the property" (p. 16); that a race of diligence among the creditors should be prevented so that the property may be "shielded and preserved as a valuable trust property by adequate "judicial protection until such time as a financial reorganization can "be perfected" (p. 16).

Accordingly, receivers were appointed for the precise purpose of preventing the enforcement of their claims by the creditors (pp. 20–22). It is elementary that this appointment gave the security holders no prior right to the application of the income for their benefit, but that it was subject in the hands of the receivers to the same rights regarding its use as if it were in the hands of the corporation (Sage vs. Memphis Co., 125 U. S., 361; Virginia & Alabama Coal Co. vs. Central Co., 170 U. S., 355; New England Co. vs. Carnegie Co., 75 Fed. Rep., 54; Veatch vs. American Loan & Trust Co., 84 Fed. Rep., 274).

Nevertheless, upon June 28, 1892, on application of the complainants and *notice to the Central Trust Company* (p.135)—which was the trustee under the consolidated mortgage (p. 28), and many other mortgages upon the system (pp. 167, 168), and made no opposition to the application (p. 135)—

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an order was made allowing the receivers to issue certificates to the amount of $1,000,000 to take up preferential claims and at the same time directing that the receivers should apply the income of the road over and above operating expenses, not to paying the current liabilities of the Railroad Company for supplies, as the same became due, but to paying "the accruing instalments on car "trust accounts and all maturing rental obligations assumed by the "Railroad Company, on any of the leases or operating contracts "upon the leased and operated roads now in the hands of the re-"ceivers, whether such rental obligations are evidenced by coupons "or guaranteed stock dividends or otherwise" (pp. 25, 137).

It is well settled that claims of this sort were not entitled to priority in equity (Kneeland vs. Loan & Trust Co., 136 U. S., 89, and 138 U. S., 509; Quincy Co. vs. Humphreys, 145 U. S., 82; Thomas vs. Western Car Co., 149 U. S., 95; Central Trust Co. vs. Wabash, 46 Fed. Rep., 26). But the petition frankly stated that the object was to "preserve the system of roads against dismemberment "* * * as well as to *preserve and increase the present market "value of the bonds and stocks belonging to the receivership*" (pp. 26, 27). The complainants and the trustee for the bondholders, therefore, joined in procuring this order directing the receivers to divert the earnings generally from their natural use in paying the current expenses of the company, and this was done for the purpose of preserving and increasing the market value of the securities.

The reorganization agreement of May 1, 1893, correctly stated the course thereafter pursued by the receivers. It said that "since "the appointment of the receivers, in June, 1892, it has been "sought to hold together the various properties embraced in each "system, and with this object in view coupons have been paid "from bonds on many properties which in themselves do not "warrant such payment (p. 512). As matters now stand (*i. e.*, "without reorganization), the system can only be held together by "paying interest on many unprofitable lines. By following this "course to some extent the receivers have become so depleted "of cash, notwithstanding the issue of receiver's certificates, "that they have been obliged to default on the interest on "all Richmond and Danville mortgage bonds, including the "two issues which are ahead of the Consolidated 5s" (p. 533, note †). The ultimate object of the plan was

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stated to be that a new company should acquire, as far as practicable, the ownership of the Richmond and Danville system (pp. 513, 514).

Inasmuch, then, as the bondholders themselves requested this diversion of the income in their own interest, it is useless to deny that it was done for their benefit.

Upon August 16, 1892, the Central Trust Company, as trustee of the consolidated mortgage, and many other mortgages upon the system (p. 168), was made a party to the suit, *upon condition that it submit to all orders theretofore entered* (p. 167.) Upon August 16, 1892, the receivership was continued *upon the Trust Company's petition* (pp. 167, 173, 174). As all action in the premises was had, to say the least, with the co-operation of the trustee for the bondholders, the facts are wholly different from those in Kneeland vs. Trust Co., 136 U. S., 189, where there was no action by the trustee. Here the bondholders are chargeable with whatever was done. It is quite erroneous, therefore, to say that the trustee was "not a party to "the Clyde suit and had no concern in it and no interest in the "relief sought" (Additional Brief for Appellant, p. 2), or that "the "mortgagee did not obtain the receivership" (Principal Brief for Appellant, p. 27).

The receivership in insolvency continued from June 17, 1892, until July 31, 1893. The receivers received, Cash on hand when they were appointed to the amount of $480,427.91, and from Accounts prior to their appointment $671,363.40, making together $1,151,791.31 (pp. 403, 424). As against this they paid upon Accounts prior to their appointment $1,237,196.22 (*Id.*). Their net payments by reason of operations prior to their appointment, therefore, amounted to only $85,404.91.

During the insolvency receivership, the receivers expended for Car Trust Payments $209,500 and Sinking Funds $67,205; for Interest and Rentals $3,249,481.89; for Construction $232,134.34 and for Equipment $81,390.32 (pp. 422, 425). Indeed, various orders authorizing permanent improvements are contained in the record (pp. 188, 248, 249, 252).

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> This shows the inaccuracy of the statements in the Principal Brief for the Appellant that "the expenditures for "construction and new equipment during the receivership "were inconsequential (p. 31)—there was little expense for "improvement or new equipment" (p. 33).

The net earnings over operating expenses, including taxes, were $3,297,792.31. These were applied to payment of the items just mentioned. The profit from operating the Richmond and Danville road proper was $346,183.10, which was not applicable as against its creditors to paying losses arising from operation of other roads (Ames vs. Union Pacific Co., 74 Fed. Rep., 335). The insolvency receivers turned over in cash to the foreclosure receivers $141,325.19 (p. 222).

The foreclosure receivership followed immediately upon the insolvency receivership; the receivers first appointed, in accordance with the order of the court, turned the property over to themselves and another as receivers in foreclosure upon July 31, 1893 (pp, 218, 240, 241).

> It is therefore error to say that the insolvency receivership was terminated and the receivers discharged before the appointment of the receivers in the foreclosure suit (Additional Brief for Appellant, p. 2).

The foreclosure receivership continued from August 1, 1893, until June 30, 1894. The foreclosure receivers between August 1, 1893, and December 31, 1893, realized net earnings to the amount of $1,127,861.09 (p. 423) and expended for Construction and Equipment $43,629.89, for Sinking Fund payments $37,790, for Car Trust payments $51,160, and for Interest and Rentals $626,735.85 (p. 432). The record does not show the amount of their expenditures for these purposes between January 1 and June 30, 1894. It does show, however, that at the close of their term there were assets on hand sufficient to pay their debts (pp. 303, 306, 307).

These figures show that during the two receiverships between June 16, 1892, and December 31, 1893, the net earnings amounted to $4,425,653.40. These were applied in paying Interest and Rentals $3,876,217.74; Construction and Equipment, $357,154.05; Car Trust payments, $260,660, and Sinking Fund payments, $104,995, amounting in all to $4,599,026.79. So that the entire earnings during the receiverships were diverted from paying the debts of the

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earnings to objects not entitled to preference for the purpose of "holding together the various properties" (p. 512); so as to "preserve and increase the present market value of the bonds and "stocks belonging to the receivership" (pp. 26, 27).

The floating debt of the Railroad Company for material and supplies amounts to merely $205,385.37, which includes the claim of the Carnegie Company, amounting to $125,067.39 (pp. 395, 398). For years the representatives of the bond and stock holders have been struggling to avoid the payment of this debt, even going so far as to assert that there was no diversion of income for their benefit.

It is idle to talk of the claim of the Carnegie Company as an effort "to displace the mortgage liens," or a claim against the *corpus* of the property (Morgan's Co. vs. Texas Central Co., 137 U. S., 171, 198). The Additional Brief for the appellant wholly misses the point when it states (p. 3) that "the question "presented is whether the mortgagees must pay the appellees' "claim out of the remnant of the corpus of the mortgaged "property, there being no surplus of earnings or income whatever "under either receivership."

The ground of the claim is diversion of the earnings from the payment of current liabilities. Of that there can be no question. As has been seen, by the order of June 28, 1892, such diversion was expressly authorized and directed (p. 137), and when the receivers in foreclosure were appointed, upon August 21, 1893, an order was entered again providing that the receivers should pay instalments on the car trust and equipment contracts and on all rental obligations of the Railroad Company, without regard to the fact that current obligations remained unpaid (p. 244). To repeat, the facts show that these receivers in insolvency received net earnings amounting to $3,297,793.31 and applied them in payment for betterments upon the property, $232,134.34 (p. 422); in payment for interest, rentals and dividends, $3,249,481.89; in payment for sinking funds and car trusts $276,705, and paid over to their successors a cash balance of $141,525.19 (p. 426); that the receivers in foreclosure during five months of their administration expended for construction and equipment $43,629.89; for car trusts and sinking funds $88,950, and

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for interest and rentals $626,735.85, and at the close had assets on hand sufficient to pay their debts (pp. 302, 303).

The Principal Brief for appellant states (pp. 20, 31) that the foreclosure receivers, after they went into possession on August 1, 1893, and before December 31, 1893, received from the prior receivership $535,167.95, and paid out on account thereof $1,040,861.31, and alleges that the foreclosure receivership thus paid out, on account of the prior receivership, $505,693.36. This overlooks the fact that $515,887.87 of these payments were for material furnished; that material to that amount was turned over by the receivers to the purchaser six months afterward, and that it was sufficient in value to discharge all debts of the foreclosure receivers at that time (pp. 302, 303). The Brief overlooks these facts also when it states that the purchasers paid into court $455,144.50 to liquidate the deficit of the last receivers' operating debts (p. 33). This was offset by the material which the purchaser received (p. 303).

This establishes that the entire earnings of the insolvency receivership, $3,297,792.91, and earnings of the foreclosure receivership to the amount of $759,315.74 were diverted to expenditures for the benefit of the security holders.

The Additional Brief for appellant meets this by asserting, first, that the bondholders are not chargeable with what was done under the insolvency receivership. To this it is it is enough to say that their trustee was a party to the insolvency suit (p. 167), and that the receivers were made permanent upon its motion (p. 167).

As to the foreclosure receivership the Additional Brief presents a statement (p. 16) for the purpose of showing that the foreclosure receivers made large payments out of the corpus of the property upon account of transactions prior to their appointment. This shows that the foreclosure receivers received for cash and accounts prior to their appointment $535,167.95. As against this are set two items which it is alleged were "paid by the foreclosure receivers for the liabili-" ties of the former receivership." *The record shows that in point of fact neither one of these items was paid by the foreclosure receivers.* The first item of the Additional Brief is "they were compelled to pay on the debts and liabilities "of the former receivership $1,237,196.22." The proof is at the page referred to (p. 403) that this item was the sum paid by the insolvency receivers between June 16, 1892, and July 31, 1893, for claims accrued by reason of operations prior to June

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16, 1892; that is to say, it was for claims arising before the insolvency receivers were appointed, and had all been paid before the foreclosure receivers were appointed. The same facts appear in the tabulated account on page 425, and are stated in the Principal Brief for appellant on pages 7, 30. The second item of the statement in the Additional Brief (p. 16) is: "And, also" (the foreclosure receivers were compelled to pay), "the certificates of the former "receivers "authorized by the court before the mortgagees became "parties, $1,000,000." Reference is made to pages 403, 404, of the record. The testimony appearing there is as follows: "Q. "Have the receivers paid any part of the principal of the "$1,000,000 of receivers' certificates? A. *They have not.*" In the tabulated statements of their operations (p. 435) no such payment appears, and the Principal Brief for the appellant (p. 8) states that they were "paid out of the sale proceeds," in accordance with the provisions of the decree (p. 11), "as a paramount charge to be paid by the purchaser" (p. 19). The statement of the Additional Brief is, therefore, wholly inaccurate, and is completely contradicted by the statement on page 34 of the Principal Brief, showing that neither of these items was paid by the foreclosure receivers.

The Principal Brief for appellant cites St. Louis R. R. Co. vs. Cleveland Co., 125 U. S., 658, 676, as ruling that the payments for interest, dividends and rentals cannot be regarded as a diversion of the income. But that was a claim for rental of a leased line, sought to be charged upon the corpus of the mortgaged premises; there was no diversion of income. So, too, with Central Trust Co. vs. Company, 80 Fed. Rep., 624. In the present case, however, the interest, rentals and dividends were paid merely for the purpose of keeping the property together for the benefit of the bondholders, and they are now the holders of securities which have resulted from the success of that effort.

As against this enormous diversion of income, really nothing is suggested, except that receivers' certificates to the extent of less than $1,000,000 were used in paying ante-receivership debts. But it has already been shown that the income from Cash on hand and Accounts prior to the receivership was only $85,404.91 less than all the ante-receivership debts which were paid (*supra*, p. 31; pp. 403, 424). Receivers' certificates were necessary only because this income was diverted to other purposes. Their use shows how entirely the income was employed in the interest

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of the bondholders. The entire income was used in holding the property together for the bondholders, and they now hold securities resulting from that course, while they vigorously try to defeat the appellee's debt. As if to add insult to injury it is suggested that proceedings having this result were "accepted and approved (by "the creditors) as being for the best interest of the whole trust es- "tate, including its own" (Principal Brief for appellant, p. 32).

In view of these facts, there is nothing in the contention that the remaining debts for materials furnished—amounting to no more than $205,385.37, including the appellee's claim—should not be paid because receivers' certificates were issued to the amount of less than $1,000,000, which ultimately went to pay in part the expenditures made in the interest of the bondholders. The complete inadequacy of the suggestion shows the absence of any defense to the appellee's claim. In the words of the Court of Appeals (p. 498), "it further "appears that the reorganization was effected through the sale "under the foreclosed mortgage to the Southern Railway Company, "and that in the reorganization the bondholders under the fore- "closed mortgage were secured by a new mortgage on the whole "system. It is a case, therefore, which does not suggest harsh "treatment of the Richmond and Danville supply creditors in the "interest of the bondholders of the foreclosed mortgage."

No clearer case of diversion of income could possibly be established, and the facts bring the case precisely within the rules laid down by the authorities. The order directing payment of this claim was, therefore, merely an application of well settled equitable principles.

Points.

THIRD.

The appellee was entitled to a lien by virtue of the Virginia statute.

When the rails in question were furnished, Section 2485 of the Code of Virginia provided that * * "All persons furnishing railroad iron, engines, cars, fuel, and all other supplies necessary to the operation of any railway, canal or other transportation company, or of any mining or manufacturing company, chartered under or by the laws of this state, or doing business within its limits, shall have a *prior lien on the franchise, gross earnings and on all the real and personal property of said company* which is used in operating the same, to the extent of the moneys due them by said company for such * * supplies; and no mortgage, deed of trust, sale, hypothecation or conveyance executed since the twenty-first day of March, eighteen hundred and seventy-seven, shall defeat or take precedence over said lien."

This section was amended upon February 15, 1892, (Virginia Statutes, 1891-1892, p. 362), but the amendment contained the proviso that "no right to or remedy upon a lien "which has already accrued to any person shall be extended, "abridged or otherwise affected hereby" (p. 363). It will be recalled that the rails had all been purchased and furnished prior to this amendment (*supra*, p. 2), so that it is without present importance.

The Brief for appellant states (p. 49) that "the Virginia "Code regulating liens on railroads, provides that no mort"gage, deed of trust, etc., *executed after* the taking effect of "such Code on May 1, 1888, shall defeat or take precedence "over said lien." It will be observed that the Code contains no such language. It provides that one furnishing railroad iron shall "have a prior lien, and no mortgage or deed of "trust, sale, hypothecation or conveyance executed since the "twenty-first day of March, eighteen hundred *and seventy-"seven shall defeat or take precedence over said liens.*" The Code, therefore, contains no recognition of mortgages executed prior to May, 1888, as prior to the lien.

This section went into effect upon May 1, 1888. The mortgage did not take precedence of the statutory lien because it was dated before that day. A mortgage is not a debt, but a mere security for a debt. It has no contractual force until the debt

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which it secures comes into existence (Schafer vs. Reilly, 50 N. Y., 61; Lord vs. Yonkers Gas Co., 99 N. Y., 547, 556; Hubbell vs. Syracuse Iron Works, 14 N. Y. Supplmt., 345).

As was said in Carpenter vs. Langan, 16 Wallace, 271, 277, "the mortgage can have no separate existence. When "the notes are paid, the mortgage expires, it cannot survive "for a moment the debt which it secures. The mortgage "is a mere incident of the debt which it is given to secure." See also Moore vs. Burnett, 11 Ohio, 334, 342.

Until that time there is no *cestui que trust;* therefore, there is no trustee; no party to whom the mortgage can be delivered so as to have binding force and as delivery is a necessary part of execution of a written contract there is no "execution" of the mortgage. "A first mortgagee, whose mortgage is taken to cover "what is then due, and also future advances (within a fixed "amount), cannot claim the benefit of such advances in priority "over a second mortgagee, of whose mortgage he had notice "at the time of its execution, and before he made these new ad-"vances" (Hopkinson vs. Rolt, 9 House of Lords Cases, 514; Bradford Banking Co. vs. Briggs, 12 App. Cas., 29). It follows necessarily that the mortgage took effect as security for the bonds only to the extent, *and at the time*, of their actual issue. In Newgass vs. Atlantic Co., 56 Fed. Rep., 676, this precise point was decided under the statute now involved. The mortgage there had been recorded prior to May 1, 1888, and some of the bonds issued before and some after that date. The court said that "the finding "of the master that only the bonds issued before May 1, 1888, were "a prior lien * * * is clearly right."

The case of Central Trust Co. vs. Continental Iron Works, 51 N. J. Equity, 605, cited by counsel at the argument below, will be found to be decided upon the authority of Jacobus vs. Mutual Benefit Life Ins. Co., 12 C. E. Green, 604, which was decided by a divided court and rests upon the peculiar language of the New Jersey statute, which expressly made the statutory lien "subject only to all mortgages and other "encumbrances created and *recorded* or *registered*, prior to the "commencement of the building" (p. 611). Upon any view of the cases, they are inconsistent with sound reason and settled principles of equity. Logically considered, they lead to the absurdity that a mortgage which is intended only as a security for a debt, may take effect to the exclusion of a statutory

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lien, when in fact there is no such debt. The cases of Brooks vs. Railway Co., 101 U. S., 443, and Meyer vs. Hornby, *Ibid.*, 728, show that a different view is taken of the matter by this court.

The case of Claflin vs. Railroad Co., 4 Hughes, 12, so far from supporting this contention, is distinctly against it. The facts of the case are somewhat complicated, and, in order to properly understand some expressions of the opinion, they must be read in connection with the facts upon each point covered thereby. One of the elementary propositions asserted in the opinion is "that, as "a mortgage is but an incident of the debt it secures, if there "is no debt, there can be no mortgage" (p. 20). Again the opinion says, "the contract with the individual bond-"holder is no more than that he shall have his due propor-"tion of the security the mortgage on its face implies" (p. 21). The necessary and logical deduction from these propositions is that *only* to the extent that there are bondholders is the mortgage effective for any purpose.

The question was one of priority as between holders of two classes of bonds secured by different mortgages, namely, a first and second mortgage. It was claimed by holders of bonds secured by the second mortgage that they were entitled to priority over certain bonds secured by the first mortgage, because the latter were not issued and in the hands of *bona fide* holders prior to the issue of the bonds secured by the second mortgage. It appears from the opinion that the "surplus bonds" secured by the first mortgage had been used as collateral prior to the date of the second mortgage; that when taken in by the mortgagor they had not been canceled, but were kept on hand to be used as wanted. After stating this fact the court said, "the second "mortgage trustees might have required all on hand when the "second mortgage was made to be retired, and the lien of the "first mortgage confined to those already out. This, how-"ever, they did not see fit to do, and, consequently, the "rights of those they represent depend on the *effect to be* "*given the instrument they took;* and in this, as it seems to "me, the intention of the company to keep the first mort-"gage on foot as a standing and continuing security to the "*full extent of the originally authorized issue* is clearly mani-"fested. The language is 'that the mortgage hereinabove "'granted shall be and continue at all times subject to the "'lien of the mortgage executed by the South Carolina Rail-"'road Company to Henry Gourdin, H. P. Walker and

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> " ' James M. Calder, and to all renewals or extensions of said
> " ' mortgage or of the bonds secured thereby, to the full
> " ' amount of the principal of said bonds.' This, I think,
> " means not only the principal of the bonds then out, but of
> " all that might thereafter lawfully be put out under the
> " mortgage, as well. The use which the company had been
> " making, and which it was no doubt expected would be con-
> " tinued, of the surplus bonds remaining after providing for
> " the old issues, must have been in the minds of all. One of
> " the trustees under the second mortgage was at the time a
> " director of the company, and the idea of actually canceling
> " any of the old lien in favor of the new seems never to have
> " been suggested by any one " (pp. 19, 20). So that the question in that case was one of intention of the parties as derived from and explained by the language of the second mortgage and the circumstances attending the issue of bonds and execution of the mortgages. There was no question of priority of a statutory lien over unissued bonds, and it seems clear from the opinion that upon the facts of this case the court would have given priority to the statutory lien.
>
> The case of Central Trust Co. vs. Louisville Co., 70 Fed. Rep., 282, seems to support the appellant's contention that the owner of property, by putting a mortgage upon it, can defeat any liens thereon irrespective of whether the mortgage secures any indebtedness. This is not in accordance with well-settled rules and would be an easy way to defeat the rights of lienors and creditors.

The statute, therefore, established a priority of lien against all mortgage bonds issued subsequently to its passage on May 1, 1888. The proof (pp. 386–389) shows the total amount of bonds outstanding, and secured by the mortgage to be $4,527,000. Of this amount $1,621,000 were issued prior to May 1, 1888, and the remainder, $2,906,000, were issued subsequent to that date, and, to a great extent, subsequent to the sale and delivery of the rails in question (p. 385). The bonds issued subsequent to May 1, 1888, were, therefore, subject to the terms of this lien statute; the appellee has a lien for the materials which it furnished prior to the lien of the bonds so issued and amounting to $2,906,000.

In the course of the vigorous efforts which appellant has made to avoid paying for these rails, it has urged several objections to this statutory lien. These will now be considered separately.

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1. It has been urged that the statute does not apply here, because the rails were purchased by and delivered to the Railroad Company in Pennsylvania on board cars for transportation to a point in Virginia.

There is no foundation for this point in the statute. It makes no reference either to delivery or use within the state. The lien exists, provided the supplies be furnished to any company "chartered "under or by the laws of this state, or doing business within its "limits." But, still further, in the present case the contract of purchase (pp. 370–374) shows that the rails were to be shipped to points in Virginia, Strasburgh or Lynchburgh, and it can make no possible difference in principle whether the purchase and delivery took place in Pennsylvania. The Railroad Company was none the less "a railway campany chartered under and by the laws of Virginia" and sales to it were none the less within the terms of the lien statute.

The case of Birmingham Iron Foundry vs. Glen Cove Starch Manufacturing Co., 78 N. Y., 30, cited by opposing counsel at the argument below, does not support his contention. In that case a Connecticut corporation contracted to build an engine for the defendant and furnish a suitable man to superintend its erection on defendant's land in New York. The Connecticut company procured the plaintiff, another Connecticut corporation, to *make for it* and *deliver to it in Connecticut* a bed-plate for the engine, without, as appears from the report of the case, any reference to the original contract. The plaintiff, which built the bed-plate and delivered it in Connecticut, not being paid therefor by its employer, sought to establish a lien on defendant's land in New York under a New York lien statute. The Court of Appeals naturally held that there could be no lien under the New York statute for work ordered, completed and delivered in Connecticut under such circumstances. Upon these facts there was no privity between the plaintiff and defendant. Had the original contractor with the New York defendant sought to enforce a lien under the statute for the engine built and set up on defendant's land in New York, the case would have been altogether different, although, nominally, the title to the engine was to pass upon delivery in Connecticut. It is to be observed, however, that the court entertained grave doubt whether the engine was an "improvement upon land" within the meaning of the New York statute.

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The case of St. Louis Bridge and Construction Co. vs. Memphis, Carthage and Northwestern Co., 72 Mo., 664, is more to the point, and is distinctly against this contention. The statute of Missouri gave a lien to "all persons who shall do any work or labor in constructing "or improving the roadbed, etc., of any railroad com- "pany incorporated under the laws of this state, * * * "and all persons who shall furnish ties, fuel, bridges "* * * to such railroad company." The defendant, a railroad corporation of Missouri, extended its road into Kansas, and plaintiff furnished materials for and did work upon a bridge of the company in Kansas. It was held that there was nothing in the act restricting the right to a lien to those who perform work or furnish supplies within the limits of this state; and, further, that, if a part of the railroad lay within and a part without the state, a lien might be enforced against that part within the state, though the work was done or material furnished on the part without the state.

2. It has been claimed that there can be no lien, because after the Railroad Company received the rails it saw fit to use a large part of them otherwise than upon its main line.

This, however, is covered by the suggestions just made. The statute gives the lien to one who furnishes supplies to a company "chartered under or by the laws of this state, or doing business "within its limits." The lien does not depend upon the use which the company sees fit to make of the materials furnished. That circumstance is quite immaterial.

In Brooks vs. Railway Co., 101 U. S., 443, and Meyer vs. Hornby, *Id.*, 728, this precise question was decided against this contention. A lien was claimed for work done upon a railroad; it was contended that the lien affected merely the precise part of the line upon which the work was done, but the court held that it covered the entire line.

In the very recent case of Virginia & Alabama Coal Co. vs. Central Railroad Co., 170 U. S., 355, it was urged that there could be no lien on the main line for coal used on branches, but the court held that the main line was liable for coal consumed on any part of the system. To similar effect are Farmers' Loan and Trust Co. vs. Newman, 127 U. S., 649, 659, 660; Central Trust Co. vs. Wabash Co., 30 Fed. Rep., 332; Central Trust Co. vs. Georgia Pacific Co., 87 Fed. Rep., 228.

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3. Appellant has objected to the lien upon the ground that there was no notice thereof filed within six months after the claim fell due. But, under the circumstances of the present case, there is nothing in this.

The notice is required by Section 2486 to be filed "within six "months after his claim has fallen due"—that is to say, a considerable time after the materials have been furnished. But the terms of Section 2485 are that "all persons furnishing railroad iron "* * and all other supplies necessary to the operation of any "railway * * company * * chartered under or by the laws "of this state * * shall have a prior lien on the franchise, "gross earnings, etc., * * of said company." The lien, therefore, being dependent upon the fact of furnishing the material, is effective from that moment. This is the provision of the statute and so it is held by authority.

> In Merchants' Bank vs. Dashiell, 25 Grattan, 616, an act of the Legislature of Virginia of July, 1870, gave to parties performing labor or furnishing material for the construction, repair and improvement of any building or other property, *a lien as hereinafter provided*, and provided that "a general "contractor wishing to avail himself of the lien given "him by the preceding section, shall file within thirty "days after the *completion* of the work, in the clerk's "office of the county or corporation court, of the county "or corporation in which the property upon which a "lien is sought to be secured is situated, * * a true "account of the work done or material furnished, sworn to "by said claimant or his agent, with a statement attached "signifying his intention to claim the benefit of said lien." Under this statute a claim of lien was asserted by a contractor who was prevented by the owner from completing the building. The claim was resisted upon the ground that, the building not having been *completed*, the case provided for by the statute had not arisen and could not arise. It was held that the act created a lien which attached to the property as soon as the work was commenced, "so that while it is in the "course of construction no notice is necessary. After it is "completed and delivered to the owner, (the mechanic) in "order to retain his lien, must, within thirty days, comply "with the requirements of the statute. And this is required "in order to notify all persons dealing with the owner that

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" the mechanic's lien to which the law gives preference still " attaches to the property " (p. 625).

The same thing was held in Courtney vs. Insurance Company of North America, 4 U. S. Appeals, 140 ; Central Trust Co. vs. Richmond Co., 31 U. S. App., 675, 688.

The notice, then, does not create the lien. It merely gives public notice of its continued assertion. In the present case, therefore, the lien attached when the rails were furnished. Section 2486 requires the notice to be filed " within six months after his claim has " fallen due." In Newgass vs. Atlantic & Danville Railway Company, 56 Fed. Rep., 676, 683, the court said in applying this section, " this statute is too plain to bear discussion. The date of " furnishing the supplies has nothing to do with it. It is governed " by the date when the claim matures. If the claim is payable in " instalments, the statute means six months after the last instal- " ment is due, for the claim has certainly not fallen due until all " the instalments are due." And the fact that a term of credit was given did not defeat the lien (McMurray vs. Brown, 91 U. S., 257; Chicago Ry. Co. vs. Union Mill Co., 109 U. S., 702, 721, 722; Van Stone vs. Stillwell Co., 142 U. S., 128, 136).

To similar effect are Central Trust Co. vs. Chicago Co., 52 Fed. Rep., 598; Fidelity Trust Co. vs. Roanoke Iron Co., 81 Fed. Rep., 439, 450, 451.

The last instalment matured on October 7, 1892 (*supra*, p. 2.) or as the Appellant's Brief concedes (p. 14), in any aspect of the case upon May 28, 1892, as to a small part of the claim, and later as to the balance. The appellee, therefore, had until six months thereafter to comply with the statutory requirement regarding the filing of notice.

As already stated, upon June 15, 16 and 17, 1892, orders were made in the Clyde case appointing receivers of the property of the Railroad Company (pp. 20-23, 155). On August 16, 1892, before the appellee's time to file the statutory notice had expired or even begun to run, as to the greater part of its claim, the court entered an order, in the same case, appointing M. F. Pleasants and Thomas S. Atkins, Special Masters in Chancery, " to hear evi- " dence and take the necessary accounts and report to the court " with all convenient speed the amount, and nature of *all* the in- " debtedness of the said Richmond and Danville Railroad Com-

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"pany, and whether secured by mortgage, pledge or *other lien* upon "any portion of the corporate property," etc. (p. 173). It has been seen that the appellee then had a valid and subsisting statutory lien upon the "franchise, gross earnings, and all the real and personal "property of said company." The Circuit Court, at this stage, took possession of the property, and directed its masters to take proof regarding the indebtedness of the company, and any *liens* on the property.

The appellee could not have filed any notice before this time for that could not be done until "within six months *after* his claim "has fallen due," and its claim for the most part did not become due until after the masters were appointed. As already said, in the meantime the Circuit Court took possession of the property and proceeded with its administration. It would have been entirely futile after this to file a notice of lien. No other court could enforce the lien and the reason for filing the notice had ceased to exist—there was no necessity of giving record notice to other parties in interest of the existence of the lien. The jurisdiction of the Circuit Court over the property and assets was complete and exclusive, and it was proceeding to ascertain all the facts. No one could be prejudiced by failure to give record notice of the existence of the lien or aided by giving such notice. Accordingly, it is well settled that the notice was not necessary.

> In Richmond vs. Irons, 121 U. S., 27, 51–55, the action was a creditor's bill. It was held that the rights of creditors became fixed by the filing of the bill and were not affected by anything which happened thereafter, as the running of the statute of limitations.
>
> In Seventh National Bank vs. Shenandoah Iron Co., 35 Fed. Rep., 436; Newgass vs. Atlantic & Danville Co., 56 Fed. Rep., 676, 683, and again, 72 Fed. Rep., 712, 716; Fidelity Co. vs. Roanoke Co., 81 Fed. Rep., 439, 453, under this identical statute it was held that after appointment of masters to take proof of claims, it was unnecessary to file any notice of lien.

There is, therefore, nothing in these various objections urged by the appellant and the appellee was entitled to a lien by virtue of the Virginia statute.

Points.

Third. The appellee has a statutory lien.

It seems unnecessary to follow the refinements of Appellant's Brief (pp. 40–63), as to the relative rights of the holders of bonds issued before and after May 1, 1888, or as to the manner in which the court will enforce this lien. These are not practical questions. It has already been abundantly shown that the sale in foreclosure was merely a step in the reorganization under which the appellant was organized and the former bondholders became holders of its securities, and that the court at all times carefully reserved the right to direct the purchaser to pay claims having priority to the consolidated mortgage (pp. 281, 282, 298). The court has found that the appellee had such priority and has directed payment of its claim by the purchaser. The questions raised are therefore without importance or present application.

Points.

FOURTH.

As to creditors of the Richmond and Danville Company, the plan under which the appellee was organized was ineffectual, and the property in its hands is subject to the debts of the former company.

Upon June 15, 1892, the bill in the Clyde suit was filed. This was the first step in the proceedings which led ultimately to formation of the appellant. The bill alleged that "an eminent banking "firm of New York City" was investigating the Richmond and Danville Company's affairs with the view of preparing a plan of reorganization, but had reached no conclusion, and any reorganization would require considerable time (pp. 14, 15); "that the unity "of the property, as now held and operated as an important trunk "line, constitutes one of the most important ingredients of its value, "and that to permit its severance will result in a ruinous sacrifice "to every interest in the property; * * that, unless the "court, in view of the impending and inevitable defaults (set forth "in the bill), will deal with the property as a single trust fund and "take it into judicial custody for the protection of every interest "therein, immediately upon default, individual creditors will "assert their remedies in different courts in the several states; a "race of diligence will result. Judgments and priorities will be "attempted, * * and a most important and valuable trust prop- "erty will be dismembered by the clashing decrees of the many "courts exercising jurisdiction at the suit of separate creditors, "which might be shielded and preserved as a valuable single trust "property by adequate judicial protection until such time as a "satisfactory financial reorganization could be perfected" (p. 16).

No default had then been made in the payment of interest or rentals (pp. 400, 401), but the bill was filed by certain stockholders and creditors to hinder the creditors generally from enforcing their rights, and to hold the property together for purposes of reorganization (Sage vs. Memphis Co., 125 U. S., 361; Brown vs. Lake Superior Co., 134 U. S., 530; Leadville Co. vs. McCreery, 141 U. S., 475).

Upon the same day, June 15, 1892, an order was, accordingly, made by the court appointing Huidekoper and Foster as receivers

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of all the property of the Railroad Company (p. 20), and upon August 16, 1892, *upon motion of the Central Trust Company as representing the bondholders*, the appointment of these receivers was made permanent (pp. 167, 172).

Under date of May 1, 1893, a plan for the reorganization of the Richmond and Danville Railroad, together with the other properties connected therewith, was issued by Drexel, Morgan & Company (pp. 503–563). This was attached to the petition of the appellee and admitted by the answer (pp. 367, 377, 378). It stated that the Railroad Company had stock outstanding to the amount of $5,000,000, nearly all owned by the Richmond Terminal Company, and floating debt to the amount of $7,000,000 (p. 507). It stated also that, "since the appointment of "receivers, in June, 1892, it has been sought to hold together the "various properties embraced in each system, and with this object "in view coupons have been paid from bonds on many properties "which in themselves do not warrant such payments" (p. 512). Participation in the plan was conditioned upon deposit of securities with Drexel, Morgan & Company (p. 512). The ultimate object of the reorganization was that the new company should acquire, so far as practicable, the ownership of the Richmond and Danville system (pp. 513, 514). The new company was to issue $75,000,000 of preferred stock and $160,000,000 of common stock (p. 516).

It will be recalled that the stock of the Richmond and Danville Company was nearly all owned by the Terminal Company (p. 507). In the adjustment of "Terminal securities" it was provided that (1) the holders of Terminal Company preferred stock should receive thirty-five per cent in new preferred stock and sixty-five per cent in new common stock; (2) holders of Terminal Company common stock (on payment of an assessment of $12.50 per share), should receive twelve and one-half per cent in new preferred stock and one hundred per cent in new common stock (p. 521). (3) The holders of $5,500,000 of Terminal six per cent bonds were to receive certain bonds and preferred stock of the new company, and in explanation of the basis of this adjustment it was stated that the Terminal bonds were secured, among other things, by $1,760,000 of the capital stock of the Richmond and Danville Company, and by a

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lien on $2,500,000 additional Richmond and Danville stock subject to the lien of Terminal preferred stock (p. 522). (4) The holders of $11,000,000 of Terminal five per cent bonds were to receive certain proportions of the preferred and common stock of the new company (p. 521), and in explanation of this it was stated that these bonds were secured, among other things, by $708,100 of the stock of the Richmond and Danville Company and by a lien on $2,500,000 additional Richmond and Danville stock (pp. 522, 523).

These provisions in favor of the holders of Terminal securities were, therefore, in large part based upon the fact that they held the stock of the Richmond and Danville Company. Accordingly, as a reason for assessment of the Terminal common stock, it was stated that, "as the Terminal owns practically all the R. & D. stock, an "assessment of $7,000,000 upon it becomes necessary to clear off the "R. & D. debt" (p. 524).

On or about June 30, 1893, the Central Trust Company filed in the same court a bill to foreclose the consolidated mortgage of the Richmond and Danville Railroad Company (p. 223). Upon March 1, 1894, the Carnegie Steel Company, Limited, this appellee, filed a petition setting forth its claim and alleging, among other things, that, although the reorganization plan provided for payment of the floating debt, the reorganization committee did not intend to carry it out in that respect (p. 368), and the plan provided for issuing new securities to the stockholders of the old company, which course would be in fraud of its creditors (p. 368). The petitioner, therefore, prayed to be allowed to intervene for protection of its rights (p. 370), and by order entered the same day it was joined as a defendant in the cause (p. 375).

On April 13, 1894, a decree of foreclosure was entered and a sale of the premises was ordered (pp. 262–276). It was ordered also that the purchaser should take subject to any claims which might thereafter be adjudged prior to the consolidated mortgage bonds (pp. 280, 282). Upon June 15, 1894, a report was filed of the sale under the decree, setting forth that the property had been sold for $2,030,000, subject to all preferential claims (p. 291). On the same day an order was entered confirming the sale subject to all claims which might be adjudged to have prior equity (p. 298), and the

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court reserved the right to enter orders binding upon the purchaser, the Southern Railway Company, directing payment of such claims and to order a resale if the same should not be made (pp. 298, 301)

All these proceedings were, therefore, merely steps in the process of reorganization. The bill in the Clyde case alleged that a reorganization was in contemplation and the plan was subsequently devised, providing that holders of Termiual Company bonds and preferred stock should receive large amounts of bonds and common and preferred stock of the reorganized company, without the payment of any assessment, for the reason that they were holders of stock of the Richmond and Danville Company. The plan provided also that holders of common stock of the Terminal Company should, upon paying a large assessment, receive stock in the reorganized company because they were holders of stock in the Richmond and Danville Company. The necessity for this was said to arise from the fact that the cash was needed in order to pay off the floating debt of the Richmond and Danville Company. The existence of that debt and the necessity of paying it were, therefore, fully recognized.

Thereafter the foreclosure was had merely for the purpose of carrying out the plan; the appellant, The Southern Railway Company, was organized and became the purchaser. The stockholders of the Richmond and Danville Company have received their securities in the new company, and are, therefore, *pro tanto* the owners of its property, but the present effort is to avoid payment of the small amount still remaining unpaid of the floating debt of the former company.

It is clear that this result by which the stockholders of the former company are preferred to its creditors is fraudulent as to such creditors. As this court of equity still has control of the property (pp. 260, 262, 298) it will direct payment therefrom of such debt in preference to any rights of such former stockholders.

The general rules upon the subject have been stated by this court as follows: "Moneys derived from the sale and transfer of "the franchises and capital stock of an incorporated company are "the assets of the corporation, and, as such, constitute a fund

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"for the payment of its debts; and, if held by the corporation "itself, and so invested as to be subject to legal process, the fund "may be seized by a creditor on such process, and subjected to the "payment of the indebtedness of the company. Where the fund "has been improperly distributed among the stockholders, or "passed into the hands of third persons not *bona fide* creditors or "purchasers, the established rule in equity is, if the debts of the "company remain unpaid, that such holders take the fund charged "with the trust in favor of the creditors, which a court of equity "will enforce and compel the application of the same to the satis-"faction of the debts of the corporation" (Scammon vs. Kimball, 92 U. S., 362, 367). It is well settled that these rules apply to all agreements or arrangements which reserve benefits to stockholders without providing for payment of the debts of a corporation. It makes no difference that the result is accomplished by means of a judicial sale or of a statute.

In Railroad Company vs. Howard, 7 Wallace, 392, an agreement was entered into among the holders of the stock and bonds of the Mississippi and Missouri Railroad Company for the foreclosure and sale of the property of the company. Another railroad company had already offered to pay $5,500,000 for the property, and it was agreed among the said stock and bondholders that the purchase money should be distributed among them at varying rates. The stockholders were to receive sixteen per cent of the par value of their stock, amounting to $552,400. A committee was appointed to arrange the details of the sale and the mode of payment by the purchasing company, and was instructed to make an arrangement with some trust company to receive the bonds and stock of the parties assenting and issue certificates therefor, setting forth what the holder thereof was entitled to receive. This agreement was carried out, and the property sold under foreclosure to a new company organized for the purpose, which subsequently was consolidated with the purchasing company under the name of the Chicago, Rock Island and Pacific Railroad Company. The amount payable to the stockholders was not, however, distributed, and creditors of the Mississippi and Missouri Company filed their bills against the new company for the purpose of subjecting the fund to payment of their debts. The court laid down the rules which have just been stated, and held that they

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applied to this case, and that the result was that the agreement that the bondholders should receive part of their debt in satisfaction, while a part of the proceeds should go to the stockholders, was fraudulent as against general creditors not secured by the mortgage, and this, although the road was mortgaged far above its value and on a sale in open market did not bring nearly enough to pay even the mortgage debts, so that in fact if there had been an ordinary foreclosure and one independent of all arrangement between the mortgagees and the stockholders the whole of the proceeds of sale would have gone to the mortgagees.

It will be seen that this case was precisely parallel to the present. For here the parties in interest first entered into a preliminary agreement regarding the disposition of the property among themselves which secured to the stockholders very considerable rights therein, some upon condition of paying assessments, but the majority without any such payment, and then the foreclosure followed merely as an incident of this arrangement and the creditors remain unpaid. There is, therefore, no difference between these facts and those in the Howard case.

In Chicago Ry. Co. vs. Third National Bank, 134 U. S., 276, a corporation leased its property leaving debts unpaid. It appeared that the lessee received the property subject to a lien of $1,100,000 and put a lien upon it from which $3,000,000 were realized. It was held that a corporation in debt could not transfer its entire property by lease so as to prevent its application at full value to the satisfaction of the debts of the company, and the court decreed payment of the lessor's debts by the lessee.

In Angle vs. Chicago Ry. Co., 151 U. S., 1, it was held that a single stockholder in a corporation could not secure a transfer to himself of all the property of a corporation so as to defeat its debts, even by a statute.

In Farmers' Loan and Trust Co. vs. Missouri Ry. Co., 21 Fed. Rep., 264, the bondholders obtained a decree to foreclosing a mortgage upon the property of the Missouri Company, but instead of making a sale of its property entered into an arrangement among themselves, with the consent of all parties to the suit, by which the entire property was transferred by perpetual lease to another company which stipulated to pay to a receiver provided for in the order of the court made under such arrangement, as rental, thirty per cent of the gross earnings of the road which might accrue from the lessee's operation thereof. This was to be applied by

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the receiver in payment of interest on the bonds issued by the lessee company and accepted in lieu of the bonds of the lessor and secured by mortgage upon the whole property of the lessor company; any surplus was to be paid to the lessor company. There was thus no provision made for payment of the floating debt of the insolvent corporation. The holders of certain unsecured notes given in liquidation of the debts growing out of the construction of a part of the insolvent road, intervened after the foreclosure decree, and prayed to have their debts established as equitable liens upon the property and funds of the insolvent road paramount to the lien of the mortgage. It was held that they were entitled to the relief prayed.

In Chattanooga Co. vs. Evans, 66 Fed. Rep., 809, it was held that an arrangement entered into whereby the property of an insolvent railroad company was sold and the proceeds distributed among the stockholders was fraudulent and void as against unsecured creditors, and that the property could be followed by such creditors into the hands of a purchaser with notice.

So, too, in the following cases it is held that equity will not permit the shareholders of a corporation to form a new corporation and transfer the assets to it without paying the debts of the former corporation: Hibernia Insurance Co. vs. St. Louis Co., 13 Fed. Rep., 516; McVicker vs. American Opera Co., 40 Fed. Rep., 861; Abbot vs. American Hard Rubber Co., 33 Barb., 578; affd., 11 Abb. Pr., 204; Cole vs. Millerton Iron Co., 133 N. Y., 164; Skinner vs. Smith, 134 N. Y., 240; People vs. Ballard, 134 N. Y., 269; Vance vs. Coal Co., 92 Tenn., 47; San Francisco Co. vs. Bee, 48 Cal., 398. Even a majority of stockholders have no right to transfer the property in disregard of the rights of the minority (Ervin vs. Oregon Co., 20 Fed. Rep., 577; 27 *Id.*, 625), although it be done by legal proceedings (Farmers L. & T. Co. vs. N. Y. & Northern Co., 150 N. Y., 410).

As against these well-settled principles, some reliance is had on Paton vs. Northern Pacific Co., 85 Fed. Rep., 838, but the court expressly distinguished that case from the Howard case upon the ground that the reorganization agreement did not precede, but followed, the foreclosure, and that the only value of the common stock of the new company arose from the assessment paid. These circumstances distinguish it also from the present case.

It is clear, therefore, that this plan to continue to the stock-

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holders of the Richmond and Danville Company an interest in this property without paying the debts of the latter company is ineffectual as to its creditors, and that the property is subject to their rights. This court of equity, having control of the property, will order payment of such claims by the organized stockholders of the former company who are the real purchasers, and present owners of the property under the name of the Southern Railway Company.

Points.

FIFTH.

Interest was properly allowed upon the claim of the appellee.

The general rule is, of course, that in the case of a contract liability, the creditor is entitled to interest from the time when the same becomes due.

The appellant, however, claims that this rule has no application to the present case, and in behalf of its contention cites Thomas vs. Western Car Company, 149 U. S., 95, 116. This authority has no present application. The question there was not regarding diversion of the earnings of the property, but whether interest should be allowed out of the *corpus* of the mortgaged premises. The court held that under the circumstances of the case it should not, inasmuch as those proceeds were far less than sufficient to pay the mortgage debt. It stated the rule that after property of an insolvent passes into the hands of a receiver or assignee in bankruptcy interest is not allowed on claims against the fund.

But this, of course, applies merely to the distribution of a fund among creditors of equal rank and equally entitled to share therein, and perhaps applies to its full extent only where the fund is insufficient to pay such claims in full with interest. If the fund is sufficient to pay interest, the creditors are entitled thereto, and any creditor having a superior equity is entitled to interest prior to any payment to the parties next in rank (National Bank of the Commonwealth vs. Mechanics' Bank, 94 U. S., 437, 441; Richmond vs. Irons, 121 U. S., 27, 64; Nashua & Lowell Co. vs. Boston & Lowell Co., 61 Fed. Rep., 237, 246-252). In New England Railway Company vs. Carnegie Steel Company, 75 Fed. Rep., 54, the court said that if the petitioner had shown that there was a fund in the hands of the receivers or their privies especially applicable to the payment of petitioner's claim, which would not have been exhausted by the allowance of interest, the interest might perhaps have been computed. This is precisely what the court below in the present case has found to be the fact.

The earnings diverted for the benefit of the mortgage bondholders were ample to pay the petitioner's claim with interest.

Points.

Conclusion. The decree should be affirmed.

There is, therefore, no reason why such interest should not be paid in accordance with the general rules upon the subject.

CONCLUSION.

The decree should be affirmed.

The appellee not only has an equitable lien upon the property in the hands of the appellant and a statutory lien thereon prior to the consolidated mortgage; in addition, the income was largely diverted from payment of current expenses for the benefit of the bondholders. Under well settled rules, the appellee is, therefore, entitled to payment.

P. C. Knox,
David Willcox,
Of Counsel for Appellee.

In the

Supreme Court of the United States.

THE SOUTHERN RAILWAY CO.,
PURCHASER, *Appellant*,
vs.
THE CAROLINA SPRG. CO.,
LESSEE, *Appellee*.

No. 20.
October Term,
1900.

BRIEF OF APPELLEE.

NICHOLAS P. BOSTE,
By Counsel, for Appellee.

Supreme Court of the United States.

THE SOUTHERN RAILWAY CO., PURCHASER, *Appellant*,

vs.

THE CARNEGIE STEEL CO., LIMITED, *Appellee.*

No. 39, October Term, 1898.

BRIEF OF APPELLEE.

STATEMENT OF FACTS.

On the 10th day of June, 1891, the Carnegie Steel Company made a contract with the Richmond and Danville Railroad Company for the delivery of certain steel rails, by the terms of which it was provided that certain rails therein mentioned were to be delivered by the Carnegie Steel Company on board cars at Bessemer, Pennsylvania, at thirty dollars per gross ton, for which the railroad company was to pay in its notes at four months from the date of shipment, without interest, with privilege of renewal of such notes for three months, with interest on the renewal at the rate of five per cent. per annum, and with the further privilege of a second renewal for three months, with interest at six per cent. per annum. By the terms of the contract it was further guaranteed by the Carnegie Steel Company that the freight on the rails to Strasburg, Virginia, should not exceed $1.75 per gross ton, if the rails were consigned to Lynchburg, Virginia. The rails called for by the contract were all delivered between the 25th day of July, 1891,

and the 10th day of October of the same year, and the promissory notes of the Richmond and Danville Railroad Company given therefor, which notes were subsequently renewed, and by their terms did not mature until after the date of the appointment of a Receiver in this cause, at the suit of Clyde and others against the Richmond and Danville Railroad Company. There still remains due on account of such rails to the Carnegie Steel Company the sum of one hundred and twenty-five thousand and sixty-seven 39-100 dollars, with interest thereon. By the Master's Account filed in this cause the claim was allowed a priority over certain of the bonds secured by the mortgage foreclosed by the decree of this Court, and declared not to be prior to the remainder of the bonds. To this report exceptions were filed by the Trustee of the mortgage, on the ground that the claim had no legal priority whatsoever; and by the claimants on the ground that it should have been allowed an equitable priority over all the bonds.

The Court below sustained the appellee's exception to the Master's Report and account, and overruled the exception filed by the Trustee, and entered a decree for the payment of the claim. From that decree this appeal is taken.

Points of Law.

The appellee will contend that its claim was properly allowed an equitable priority on three separate and distinct grounds:

First. For the reason that there has been a diversion of earnings so as to bring the claim within the doctrine laid down in the case of Fosdick vs. Schall, and the other cases following and supporting that doctrine.

Second. Because, independent of the doctrine of Fosdick vs. Schall, and other similar cases, there was a fund in the hands of the Receivers appointed in the case of Clyde against the Richmond and Danville Railroad Company, which fund belonged to the floating debt creditors, and

which was either turned over to or used for the mortgage bondholders, and which they should, therefore, be compelled to restore; and

Third. Because the claimant is entitled to a priority under the Virginia Statutes, as construed by this Court in the case of Newgass, which was the ground taken by the Masters in this case in making their report.

We shall consider these points in the above order:

First Point.

The doctrine announced by the Supreme Court in the case of Fosdick vs. Schall, and confirmed by it in a number of subsequent cases, is too familiar to require a very extensive statement. The Court in that case, after alluding to the fact that the business of all railroad companies is done to a greater or less extent on credit, which credit is longer or shorter, as the necessities of the case require, went on to say that every railroad mortgagee, in accepting his security, impliedly agreeds that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim on the income. If, for the convenience of the moment, something is taken from what may not improperly be called the current debt fund, it is not inequitable to require the mortgagee creditor to pay that sum back, and if the appointment of a Receiver has been ordered, such a restoration will be directed from the current receipts under the Receivership before anything from that source goes to the mortgagees. In this way, as the Supreme Court said;—the Court will only be doing what, if a Receiver should not be appointed, the company ought to do itself. The Court further went on to say:—that while ordinarily this power is confined to the appropriation of the income of the Receivership and the proceeds of moneyed assets, cases may arise where equity will require the use of the proceeds of a sale of the mortgage property in the same way, and the Court gives as an illustration of such a case

where, in the course of the administration of the case, the Court was called upon to take income which would otherwise be applied to the payment of old debts for current expenses and uses it to make permanent improvements on the fixed property, or to buy additional equipment, or otherwise to increase the value of the mortgaged property.

Again, in the case of Burnham vs. Bowen, the Supreme Court, after quoting the doctrine of Fosdick vs. Schall, to the effect that a mortgage creditor agrees that the current debts should be paid out of the current receipts before he has any claim on the income, say, that such being "the case when a Court of Chancery, in enforcing the rights of mortgage creditors, takes possession of the mortgaged railroad, and thus deprives the company of the power of disposing of any further earnings, it ought to do what the company would have been bound to do had it remained in possession; that is to say:—pay out of what it receives from earnings, what debts, in equity and good conscience, considering the character of the business, are chargeable upon such earnings." In other words:—"what may properly be termed the debts of the income should be paid from the income before it is applied in any way to the use of the mortgagees. The business of a railroad should be treated by a Court of Equity, under such circumstances, as a going concern, not to be embarrassed by any unnecessary interference with the relations of those who are engaged in or affected by it."

We therefore submit that if the claimant in this case would have had a right, if no Receiver had been appointed in the case of Clyde against the Richmond and Danville Railroad Company, to have had the current receipts of that company applied to the payment of his debt, the claimant had a right to have earnings of the receivership so applied. In other words:—whatever the company itself was bound in equity and good conscience to do, the Receivers were also bound in equity and good conscience to do. A Court

of Equity does not appoint a Receiver to perpetrate an injustice, but for the purpose of carrying out and performing the legal and equitable obligations of the company so far as may be. Or, to use the language of the Supreme Court in the case of Burnham vs. Bowen: "So far as current expense creditors are concerned, the Court should use the income of the receivership in the way the company would have been bound in equity and good conscience to use it if no change in the possession had been made." This branch of the case, therefore, resolves itself into a determination of these questions:

1. Would this claimant have been entitled, if a Receiver had not been appointed, to have had the current income applied to the payment of its claim as a current supply debt?

2. Did a fund, which the company, if it had remained in possession of the property would have been bound to apply, go into the hands of the Receivers?

3. Was such a fund so in the hands of the Receivers used for the benefit of the mortgage bondholders?

The first point we think clear. There can be no question that the claimant was a supply creditor of the Richmond and Danville Railroad Company. It is true that it gave the company credit for a considerable time by taking its notes and agreeing to an extension and renewal thereof, but it is evident from the case of Burnham and Bowen, above referred to, that the taking of notes and the renewal of the same does not prevent the creditor from being considered a supply creditor or from being entitled to look to the current receipts for payment when his notes mature. In that case it is stated in the opinion of the Court: "When the Receiver was appointed, the debt was evidenced by business paper maturing at a future date. It was no waiver of any claim on the fund which came into the hands of the Receiver to renew the paper at maturity for the convenience of the holder."

The case of Bound against the South Carolina Railroad Company has been considered opposed to this view, but the only thing decided by that case was, that during the period of the running of such notes the claimant must be considered as waiving his claim against the current income, and that, there, no use of the current income for the benefit of the mortgage bondholders during the running of the note can be considered a diversion. We therefore submit, on the authority of Burnham and Bowen, that at the maturity of the notes taken by the claimants in this case they would have been entitled to have had them paid as a supply debt out of the current receipts of the Richmond and Danville Railroad Company, if no Receiver had been appointed.

The second point—as to whether there was income in the hands of the Receivers with which to pay this claim, if it had not been diverted—we think equally clear. It appears from the report of F. W. Huidekoper and Reuben Foster, Receivers, of their operations of the Richmond and Danville Railroad System from June 17, 1892 to July 31, 1893, at which date they were discharged, that the gross earnings amounted to $11,669,789.50, and the operating expenses, including taxes, amounted to $8,371,997.19, leaving net earnings of $3,297,792.31. Of this amount they expended $559,734.62 in what they call extraordinary expenditures against net earnings. They paid for construction on the Richmond and Danville Railroad Company $19,717.05; for construction work on lines held by the Richmond and Danville Railroad Company, subject to the payment of a fixed amount of rental, the sum of $88,416.10, and construction on other leased lines the sum of $124,001.19, making a total for construction work of $232,134.34. They expended in buying equipment for the Richmond and Danville Railroad Company $74,733.28, and in equipment for the leased lines $6,657.04, making a total for equipment purchased of $81,390.32. The balance of the sum of $590,000.00 above mentioned as devoted to extraordinary expenditures made out of the net earnings was used in paying expenses

incurred prior to the appointment of the Receivers, ($185,562.13,) payment of judgments against leased lines ($9,565.39,) and Court expenses ($51,082.44.) After the payment of the above extraordinary expenditures out of the net earnings they had what they called available net of $2,738,057.69. This available net was more than exhausted by the payment of interest, rentals and dividends of over $3,000,000, of which sum $396,522.14 was paid on securities issued by the Richmond and Danville Railroad Company prior in lien to the mortgage foreclosed by the decree in this case, and the balance for interest and dividends on the securities issued by the leased lines or for rentals of the same. It also appears, however, that during this same period the Receivers paid, in addition to the above, the sum of $486,368.16 in Car Trust payments and sinking fund, of which sum $67,205 was paid on account of the sinking fund of the Richmond and Danville five per cent. equipment mortgage, and $209,500 on account of Car Trust payments. (See Record, page 422.)

It also appears from the cash account filed by the Receivers that they received from the Richmond and Danville Railroad Company at the time of their appointment $480,427.91 in cash, and that they received in settlement of accounts due the Richmond and Danville Railroad Company prior to their appointment $671,363.40. That is to say, they received of the net earnings made prior to their appointment by the Richmond and Danville Railroad Company a total amount of $1,151,791.31, and that they turned over to the Receivers appointed on the application of the mortgage bondholders on the 1st day of August, 1893, the the sum of $141,325.19, being the balance of cash on hand. (Record, page 424.)

We submit that the above figures, taken from the report of the Receivers filed in this cause, clearly show the receipt of net earnings which the defendant railroad company would have been bound to apply to the payment of this

claimant's account if it had remained in control of its property.

As to the third point—that is to say, whether or not these earnings were applied for the benefit of the mortgagees—we consider the matter equally clear. It surely cannot be denied that the item of $19,000 for extraordinary construction on the Richmond and Danville Railroad Company was an expenditure which enhanced the value of the mortgaged property afterwards sold under foreclosure. As to the items of $88,000.00 and $124,000.00 for extraordinary expenditures in construction work on the leased lines, it is to be observed that the mortgaged foreclosed in this suit was mainly to secure bonds which were to be issued by the Trustee upon deposit with such Trustee of mortgage bonds covering the leased lines of the Richmond and Danville Railroad Company, and that, as appears from the bill of complaint of the Central Trust Company, and from the decree of foreclosure, a large amount of these bonds were so deposited, and the bonds of the mortgage foreclosed in this case issued against them, and the leasehold interest held by the Danville Company in these lines assigned to the mortgagee. By the decree of the foreclosure it was adjudged that not only should the line of the Richmond and Danville Railroad Company proper be sold, but the leasehold interest in the leased lines, and the bonds on the same deposited with the Trustee under the mortgage. Construction work, therefore, done on the leased lines afterwards sold by the decree of foreclosure, operated directly to the benefit of the mortgaged property, and the income was applied to the use of the mortgagees in improving the property in which they had a leasehold interest conveyed to them by way of mortgage or a mortgage interest secured by bonds deposited with their Trustee as collateral. Again, the purchase of equipment for the Richmond and Danville Railroad Company to the amount of $74,000.00 set forth as an extraordinary expenditure against the net earnings was surely an application of the income for the use of hte

mortgagees, as the equipment so purchased was, of course, sold at foreclosure of their mortgage. The interest, rentals and dividends paid on the leased lines covered by the mortgage was also an application of the net earnings of the company in the hands of the Receiver for the purpose of preserving and retaining the title to the property afterwards sold for the benefit of the mortgagees, and the Car Trust payments and the payments on account of the Sinking Fund for the Richmond and Danville Equipment Mortgage were, in fact, payments on account of the purchase of rolling stock covered by the mortgage foreclosed in this case and sold under the decree for the benefit of the mortgagees. All of these payments, therefore, were, in fact, applications of the income in the hands of the Receivers for the benefit of the mortgagees, and if the claimant in this case was entitled to have income in the hands of the Receivers applied to its claim before the same was used for the benefit of the mortgagees, we respectfully submit that we have shown such a diversion of the income as entitles us to have it restored out of the proceeds of sale.

Second Point.

Aside, however, altogether from the doctrine of Fosdick and Schall, and the equity priority therein declared in favor of supply creditors, the claimant in this cause respectfully submits that it is entitled to be paid its claim in full. We do not understand that there is any dispute over the legal proposition that the net earnings in the hands of the Receivers appointed under a creditor's bill belong to the creditors-at-large, and not to the mortgagee. In other words, it is immaterial whether the mortgage covers the tolls and incomes or not, so long as they are not impounded and taken possession of by the Trustee under the mortgage or by a Receiver appointed at the instance of the Trustee or the bondholders.

Sage vs. The Memphis, &c., R. R., 125 U. S. 378.

Kneeland vs. The American Loan Co., 106 U. S. 103,
Gilman vs. The Telegraph Co., 91 U. S. 617.

The original bill filed in this cause was filed by William P. Clyde, John C. Mabin and William H. Goadby against the Richmond and Danville Railroad Company and the Richmond and West Point Terminal Railway and Warehouse Company. The plaintiffs alleged that they were creditors and stockholders of both the Danville and Terminal Companies, who sued for themselves and all other creditors and stockholders, and prayed a sequestration of the income of the railroad property and marshaling and ascertainment of the indebtedness and the appointment of a Receiver. As we have said, there can be no question as to the legal proposition that, under such a bill, the net income earned by the Receivers belongs to the creditors of the road generally until such time as the mortgagee demands possession. We have seen, in considering the previous proposition, that the Receivers appointed under the bill of Clyde and others made net earnings, above operating expenses, during their administration of the property of $3,297,792.31, and we have also seen that they received of the earnings made prior to the receivership the sum of $1,151,791.31, and that after making sundry payments, a large portion of which were for the direct benefit of the mortgage bondholders, and a portion directly to the mortgage bondholders by way of interest, they turned over on August 1st, 1893, to the Receivers appointed at that date under the bill filed by the Central Trust Company, Trustee under the mortgage afterwards foreclosed, a balance of cash on hand of $141,325.19. Without going over again the separate items of expenditures already considered, we submit that it clearly appears that the Court from time to time directed, or that the Receivers considered it their duty, without special direction of the Court, to make expenditures by way of betterments on the property and the purchase of equipment for

the better operation of the property, all of which expenditures were made out of money in the hands of the Receivers which belonged to the general creditors of the company, and that the property enhanced in value by such betterments, and the equipment so purchased was afterwards, by the decree of this Court, sold for the benefit of the mortgage creditors. It seems to us that, under such circumstances, it hardly needs argument to show that a Court of Equity, having had in its hands funds which belong to one set of creditors, and having used these funds for the benefit of another set of creditors, will repay to the first set of creditors what it so used out of funds in its hands belonging to the second set. The objection which is urged against this proposition is to the effect that the claimant in this cause and other creditors made no objection to such uses of the money at the time it was ordered, and that the Trustee and the mortgage bondholders, not being then parties to the case, were not responsible for the use so made. We submit that this is hardly a valid objection. It was doubtless wise in the Court and the Receivers managing the property of the defendant railroad company to do the construction work set forth in the Receivers' report and purchase the additional equipment, to pay off the Car Trust as it came due, and otherwise preserve the property for the general benefit, and no objection could successfully have been urged to such a course at the time the orders were made. As the Supreme Court said in the case of Barton vs. Baker, 104 U. S., a railroad is authorized to be constructed more for the public good to be subserved than for private gain. It is, therefore a matter of public right, when the Courts take possession of the property through a Receiver or other officer in whose charge it is placed, to continue the ordinary operations of the corporation, to run trains of cars, to keep the tracks, bridges and other property in repair, and generally to make such improvement and acquire such equipment and may be necessary for the public good and convenience, and we do not doubt that the purchase of equip-

ment and the construction work done on the line of the road was with a view to securing the public purposes suggested above; but when the Court has arrived at the end of its administration of the property and finds that, in enabling its Receivers to perform the duties owed by the corporation to the public, it has used the money of one set of creditors for the benefit of another, can there be any doubt of the Court's power and duty to restore the money so used?

Still stronger is the claim on the fund of $141,000 turned over by the Receivers appointed under the creditors' bill to the Receivers appointed at the suit of the mortgage bondholders. It was a fund unexpended by the Receivers appointed at the suit of the creditors in their hands at the time the property was taken possession of by the mortgage bondholders and the income thereafter impounded for their benefit. To this amount they were clearly in no wise entitled, it having been earned during the prior receivership.

THIRD POINT.

The third point upon which the claimant relies in this cause is the point decided in its favor by the Masters. By Sec. 2485 of the Code of Virginia, in full force and effect at the time of making of the contract with this claimant, and at the time of its furnishing the rails therein mentioned, it was provided that all persons furnishing railroad iron, cars, fuel and all other supplies should have a prior lien upon all the franchises, gross earnings, real and personal property of the railroad corporation to which said supplies were furnished to tho extent of the money due for such supplies, and that no mortgage executed since the date of the original passage of that Statute should have the effect to defeat or take precedence of such lien.

This statute, as originally passed in 1877, was held to be defective because of a failure to comply with the Constitution of Virginia in expressing the object of the Statute in its detail; but, however that may be, it was re-enacted in the Code of Virginia which went into effect on the 1st day

of May, 1888, and from and after that date it is admittedly a valid and effectual statute.

As we have seen, the contract for the furnishing of the steel rails in this case was made on the 10th day of June, 1891, and the rails were furnished between that date and the 10th day of October following. It therefore appears that at the time of furnishing the material the claimant in this cause was protected by the Statute and given a prior lien. Section 2486 of the Code went on to provide, however, that, in order to entitle a supply creditor to the lien under the previous section of the statute, he must, within six months after the claim became due, file a memorandum of the amount and consideration thereof in the clerk's office of the county Court, or, if the principal office of the corporation is located in the city of Richmond, in the Chancery Court in that city. Two objections are taken by the trustee for the bondholders in this cause to the lien of the claimants' claim as a priority over the mortgage bonds. The first is that the mortgage foreclosed in this cause, having been made and recorded prior to May, 1888, the statute then passed, by the passage of the Code, could not operate to give any supply creditor a prior lien over that mortgage. In the second place, inasmuch as it does not appear that the claimant ever filed a sworn memorandum of the amount and consideration of its claim in the Chancery Court of Richmond, it is not a valid claim within the language of the statute. The claimant submits that both of these points have been affirmatively and positively decided by this Court in construing this very statute. In the case of Newgass vs. The Atlantic and Danville Railroad Company, 56 Fed. Rep. 683, this Court held that a supply creditor had a prior lien over bonds issued subsequent to May 1, 1888, although the mortgage securing such bonds had been recorded prior to that date, holding, in substance, that persons taking bonds after the passage of that Statute secured by a blanket mortgage such as the one foreclosed in this cause, take them with notice that they are subject

to the prior equities of materialmen and others. In the case at bar it is admitted by a stipulation filed in the case that out of the $4,527,000 of bonds issued under the mortgage foreclosed in this cause, $2,906,000 were issued subsequent to May 1, 1888. We submit, with confidence on the authority of Newgass against the Railroad Company, above cited, that this claimant is entitled to a priority over $2,906,000 of said bonds. The other objection, that the claimant did not file in the clerk's office in the Chancery Court of Richmond a memorandum of the amount and consideration of its claim, we think to be equally clearly decided by the case of Newgass above referred to, and also by the case of the Seventh National Bank vs. The Shenandoah Iron Company, 35 Fed. Rep. 443, in which last case this Court, in construing identically the same section of the statute, held that the requirement of the statute to file a memorandum of claim in order to effect a lien within six months after the claim became due, was suspended by the taking possession of the bankrupt's property by the Court and the appointment of the Master, with directions to state an account showing all claims. That it is evident that this must be so appears from a very slight consideration of the circumstances of this case. The claims in this case did not come due until some time after the appointment of the Receivers. As decided in the case of Newgass above referred to, the six months within which the claim must be filed does not commence to run until the last payment agreed to be made comes due, according to the terms of the contract. In the case at bar, as we have said, before the claim became due at all, Receivers were appointed to this Court which took possession of all the property of the debtor, and Masters were appointed who were directed to state an account and report to the Court all indebtedness of the defendant company, and the various priorities existing at the date of the appointment of the Receiver and the impounding of the defendant's property by the Court for the benefit of the creditors. The Masters were also ordered to

give notice, by advertising, for all creditors to file their claims with them, and were directed to report their findings to the Court within a certain limited time. The six months within which this claimant was required to file the memorandum, under affidavit, of its claim in the State Court, extended considerably beyond the time within which the creditors were required, by the terms of the order of this Court, to file their claim with the Master, and also beyond the time within which the Masters were required to report their findings to this Court. The claimant in this cause did file with the Masters a statement, under affidavit, showing the amount and consideration of its claim, and it seems to us apparent, under circumstances like these, that a statute requiring the claim to be filed within six months after it becomes due, must necessarily be inoperative, more particularly when such a statute require that we file in another Court for the purpose of giving notice to parties, all of whom are in the Court having jurisdiction of the property, and engaged in stating an account of indebtedness.

We have paid no attention to the argument based on the amendment to the section of the Virginia Statute above referred to, which was passed on the 15th day of February, 1892, for the reason that our lien, having accrued under that statute in force at the date at which we supplied the material, was in no manner affected by that statute, which amended the prior statute by providing that the claim should be filed within 90 days after furnishing the material, instead of within six months after the claim should become due. It is apparent that that amendment could not have been intended to affect materialmen furnishing supplies more than 90 days before the amendment was passed, as, to give it such an effect, would be to deprive him altogether of his lien, which the Legislature evidently did not intend, and could not, if it did so intend, validly carry into effect.

The appellee therefore submits that on all the grounds above noted it has a valid claim to priority of payment, and that the decree below should be affirmed.

NICHOLAS P. BOND,
Of Counsel, for Appellee.